AMERICAN ACADEMY *of* ACTUARIES

October 10, 2002

The Honorable Michael G. Oxley
Chairman
Committee on Financial Services
U. S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Paul S. Sarbanes
Chairman
Committee on Banking, Housing and Urban Affairs
U. S. Senate
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairmen Oxley and Sarbanes:

The Workers' Compensation Subcommittee of the American Academy of Actuaries[1] offers the following comments addressing the need for a mechanism to provide federal funding of extraordinary workers' compensation (WC) losses that may be precipitated by future acts of terrorism, as is presently under consideration by the House-Senate Conference Committee in H.R. 3210.

While this letter specifically addresses terrorism, the concerns articulated also apply to war, since its consequences are similar and the lines between the two are increasingly blurred in today's world. Also, many of the points made herein also apply in varying degrees to other lines of insurance.

Considerations Regarding a Federal Backstop Mechanism for Funding Workers' Compensation Losses Arising from Acts of Terrorism

We recommend that Congress consider the following unique features of workers' compensation insurance when evaluating the need for a federal risk transfer and financing mechanism to deal with the financial losses from future acts of terrorism.

Existing state WC systems effectively deliver compensation and care to Americans injured in the workplace.

These systems deal with people's lives rather than property or lost profits. They are designed to fund medical treatment, rehabilitation and return to work of injured employees and the replacement of a portion of lost wages during their convalescence. They also compensate injured workers for permanent disabilities and provide long-term benefits for workers surviving dependents in cases of fatalities. WC

[1] The American Academy of Actuaries (Academy) is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice and the Code of Professional Conduct for all actuaries practicing in the United States.

benefits are intended to be delivered rapidly on a no fault basis. Given their significance to Americans most directly impacted by terrorist attacks, WC benefits are a particularly important part of our nation's response to acts of terrorism.

WC benefits are mandated by statute and medical benefits are unlimited. While the amount and duration of death and partial disability benefits are generally limited by state statute, total disability and medical benefits are generally unlimited, without any employee contributions toward those costs. The cost of benefits arising from a single claim can be very high. For example, the wage replacement benefits and ongoing medical care for a young worker totally disabled for life can exceed $10 million. For much the same reason that employers buy WC insurance, most insurers purchase "specific" reinsurance[3] (and self-insured employers buy "specific" excess insurance) to limit the losses they will have to pay (or retain) from a single occurrence, thus spreading the risk for catastrophic losses over a larger capital base.

The benefits covered by WC insurance are mandatory and terrorism cannot be excluded.

These benefits apply to all employers, whether insured or self-insured, and cannot be reduced by policy limits. They also cannot be changed to exclude terrorism, war or other causes of loss not specifically noted in state laws.

WC is a "long tail"[4] line, requiring more surplus than most other coverages.

Regulators require insurers to maintain surplus accounts to serve as a buffer in the event that reserves for prior policies prove to be too low or that actual "normal" losses arising from current policies are greater than the loss provisions built into premiums. The total losses incurred are a function of the number (frequency) and size (severity) of the claims that are filed against those policies. By purchasing specific excess or reinsurance, self-insured employers and insurers stabilize their financial results and reduce the amount of capital required to meet regulatory surplus requirements. While self-insured employers must maintain some form of security for outstanding losses, the absence of dedicated surplus and mandatory aggregate stop loss insurance[5] may make them even more vulnerable than insurers.

While the frequency of multiple claimant occurrences is still very low, the potential severity resulting from events such as terrorist attacks is substantial. Most multiple claimant occurrences result from auto accidents, scaffolding collapses, explosions, etc. that involve two to 10 workers at the most. However, the World Trade Center attack has awakened the insurance and reinsurance community to the potential for multiple claimant occurrences of enormously greater proportion. The cost of property losses arising

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[3] An insurer which assumes the insurance liability of another by way of reinsurance.

[4] A term used to describe certain types of third-party liability exposures (*e.g.,* malpractice, products liability, errors and omissions) where the incidence of loss and the determination of damages are frequently subject to delays which extend beyond the term the insurance or reinsurance was in force.

[5] A form of reinsurance which indemnifies the reinsured against the amount by which the reinsured's losses incurred during a specific period exceed either an amount or a percentage of some other business measure.

from a terrorist attack such as an explosion are easier to predict because they are related to the strength of the blast and the type and value of structures at or in near proximity to the detonation. The costs of WC losses arising from similar attacks are more difficult to predict and more difficult to reinsure because they are functions of not only the blast strength and location, but also the following additional factors:

- Applicable mandated statutory benefit levels
- The day of the week and time of day of the attack (affecting the number of workers involved in the event)
- The numbers and ages of dependents of workers killed in the attack
- The numbers, ages, and occupations of workers seriously injured and potentially requiring lifetime medical care

Reinsurance availability and affordability have changed dramatically since September 11, 2001.

In plain terms, the potential magnitude and range of possible outcomes for any WC multiple claimant occurrences, not just terrorist attacks, have caused many reinsurers to withdraw from the WC market. Of those that remain, most reinsurers have dramatically increased prices, reduced policy limits, and/or increased retentions (the amount of each loss for which the primary insurer or self-insured employer is responsible). Unlike primary WC insurers, reinsurers can exclude or reduce the coverage provided for terrorist acts under their policies, and most have. This means that a future terrorist act could lead to insolvencies for numerous primary insurers (and bankruptcy for self-insured employers) that are required to pay the benefits resulting from such an attack.

Potential WC losses from terrorist events could be disastrous.

As horrific as the September 11 attacks were, the numbers of dead and injured workers represented a small portion of the more than 50,000 employees based in the buildings destroyed. If the terrorists had detonated a “dirty bomb” or released nerve gas, permanently disabling rather than killing many victims, the cost of WC benefits incurred in the attack could have been tens, or even hundreds, of billions of dollars. Put into perspective, the annual written premium for the entire WC insurance industry is approximately $41 billion (excluding self-insureds’ costs). Thus, potential WC losses from a subsequent terrorist attack amounting to several times the yearly countrywide WC premium, the next attack could bankrupt many of the insurers and self-insureds affected, along with any reinsurers still providing terrorism coverage.

Both public and private insurance entities that provide this mandatory insurance coverage are now at heightened risk due to changes in the marketplace and the unpredictable and unfunded risk of terrorism.

In all states there is a state insurance fund or assigned-risk mechanism to provide a guaranteed (or “residual”) WC insurance market for employers. To the extent that the unavailability of reinsurance forces private insurers to non renew or decline risks with significant multiple claimant occurrence exposures, these "residual market" mechanisms may end up insuring a disproportionate share of employers operating in concentrated, high profile locations.

> **When the next terrorist attack occurs, it could easily eradicate the surplus of the state insurance funds and leave many claims to be paid by taxpayers or other WC insurers through insurance guarantee funds.**

In states with assigned risk mechanisms having no surplus, all WC insurers would pay unfunded claims proportionately. This obligation could precipitate successive company failures, leaving no insurers to provide coverage for the remaining employers in the state.

In summary, the potential negative consequences of future terrorist attacks on the health of the WC system are considerable. It is difficult to imagine a solution to this problem that would not involve the federal government. The Subcommittee stands ready to assist public policy-makers in evaluating the establishment of a federal risk transfer and financing mechanism (*i.e.*, a "backstop") to deal with the financial losses from terrorist attacks.

Thank you for your consideration. If you have any questions or would like more information, please contact Greg Vass, the Academy's senior casualty policy analyst, at (202) 223-8196.

Sincerely,

Nancy R. Treitel

Nancy Treitel, FCAS, MAAA
Chairperson, Workers' Compensation Subcommittee
American Academy of Actuaries

cc: H.R. 3210 Conference Committee Members