Commercial Mortgage Securities Association™ (CMSA)

Position Paper

Subject: Terrorism Insurance Availability for Commercial Real Estate Capital Markets

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Background: The terrorist attacks on September 11th, 2001 resulted in the horrible loss of life and insured damages of approximately $35 billion. The attacks also created tremendous uncertainty in the insurance market, which was further exacerbated by the threat of future terrorist attacks and the inability to price for terrorism risks. Consequently, reinsurers stopped writing coverage and primary insurers withdrew, or tried to withdraw, from the market, which led to dramatic increases in the price of commercial property-casualty insurance. Commercial policyholders soon faced exclusions for terrorism in standard insurance policies, and coverage became extremely expensive and altogether unavailable in certain areas. Overall, the lack of terrorism insurance threatened our country's economic security, from existing infrastructure to future construction and commercial real estate development.

The impact of this insurance crisis was then, and still is today, particularly problematic for the commercial mortgage-backed securities (CMBS) market, which provides significant capital and liquidity to the commercial real estate sector. The smooth functioning of the CMBS market depends upon the availability of "all risk" insurance coverage, including terrorism insurance. Investors and rating agencies demand terrorism insurance coverage, while lenders require that such coverage be in place in the loan documents. If terrorism coverage is not available or affordable, CMBS borrowers face the threat of default; rating agencies may downgrade related bond ratings; and investors that see the value of their investment fall may be required to divest if the bonds no longer satisfy their mandatory investment parameters. Despite the exponential growth in CMBS issuance over the last decade, the impact was especially evident after 9/11 when the lack of terrorism insurance caused negative growth in the market. In fact, new CMBS issuance declined almost 25% from 2001 to 2002 before Congress took action.

Fortunately, Congress passed, and President signed, the "Terrorism Risk Insurance Act of 2002 (TRIA)", which has served as the structure for the program that exists today. TRIA created a public-private partnership between the federal government, the property-casualty insurance industry and commercial policyholders to share future insured losses from international acts of terrorism. The temporary three-year program was administered by the Secretary of the U.S. Department of Treasury, and it required that terrorist acts meet certain conditions before accessing federal funds. Most important, the program included a requirement the insurers "make available" terrorism insurance coverage as a separate offer in commercial property-casualty policies (although policyholders are not required to purchase terrorism insurance). Among other requirements (which also still exist today) are that terrorist attacks be "foreign" in nature and that the private sector absorb a level of losses before the public-private cost-sharing occurs. This requirement includes a "Program Trigger" of aggregate industry losses (originally $5 million) that must occur in order to access federal funds, as well as an "Insurer Deductible" which requires that an individual insurer's losses exceed a percentage of their direct earned premium (originally 7%). After these thresholds are met, the program covers a percentage of insured losses above the individual insurer's deductible, known as a "Co-Share" (originally 90%), up to the program limit of $100 billion. Further, the program created an "Aggregate Retention" (originally $10 billion), which represents the amount federal losses that the Treasury Secretary has the discretion to recoup over time in the form of a "policyholder surcharge" that cannot exceed a 3% premium on an individual policy.

Overall, TRIA filled a critical void in the market and ensured the private market is able to provide the much needed and required coverage to policyholders at virtually no cost to the federal government. In fact, since TRIA's enactment in 2002, the availability of terrorism coverage has grown and premium prices have declined. The program also protects taxpayers by combining government and private sector funds (using the efficient private sector insurance loss adjustment mechanism), and it ensures the efficient distribution of loss relief, while requiring some taxpayer recoupment to the government. However, as TRIA neared expiration at the end of 2005, the conditions that prompted the enactment of law in the first place (i.e. the threat of terrorism and the uninsurable nature of the risk) had not changed, and several reports, including one by the Government Accountability Office (GAO), indicated that there would not be a sustainable market for terrorism insurance without a federal program.

Given the originally intended temporary nature of the program, policymakers debated at length the need to extend the program and considered several proposals to reform the program, but ultimately Congress passed a two-year extension of the program with relatively minor changes to its structure. The new law, the "Terrorism Risk Insurance Extension Act of 2005 (TRIEA)," went in to effect on Jan. 1, 2006 and will expire on Dec. 31, 2007. Among the changes to the program are a general phasing out of the government role over time by increasing the program trigger ($100 million in 2007), insurer deductible (20% in 2007) and aggregate retention

($27.5 Billion in 2007), while reducing the federal co-share from 90 to 85% in 2007 and eliminating certain lines of coverage (such as commercial automobile insurance, professional liability coverage) under the program.

With TRIEA scheduled to expire at year-end, it is unclear whether a private market for terrorism insurance will exist without the existence of a federal program, or the creation of new measures to expand capacity and provide a sustainable solution. Our country remains under the threat of terrorism, which is virtually uninsurable – especially as it relates to potential nuclear, biological, chemical and radiological, or "NBCR", events. Coverage for NBCR attacks – the most potentially catastrophic types of events for which there is little coverage in the market – can be excluded given that the requirement that insurers "make available" coverage does not extend to this area. As such, failure to extend legislation for both "conventional" and "NBCR" attacks would be devastating to the U.S. economy.

The lack of terrorism insurance coverage again would impact new commercial lending, as well as the more than $850 Billion in outstanding CMBS in the United States (including 40% of all new commercial loans in 2006) – which drains a meaningful source of capital and brings tremendous volatility to the market. In fact, a recent report by Fitch Ratings conclude that allowing the current terrorism insurance program to expire would have "credit implications…that include a review and potential downgrading of a specific set of CMBS transactions, and a broad reduction in lending, possibly leading to greater defaults and downgrades across the broader CMBS universe." Clearly, the potential impact on our economy is broad and deep – from new commercial real estate development to existing investors. These investors include the pension and mutual funds of millions of Americans whose portfolios are heavily invested in CMBS.

CMSA Position: The top legislative priority of CMSA is the enactment of a sustainable solution to terrorism risk insurance, which is crucial to the CMBS market. Today, lenders require (and investors and rating agencies demand) terrorism risk coverage, and without affordable policies, CMBS borrowers face the threat of default and investors face potential downgrading of bond ratings.

Given these realities, CMSA is working with Congress to extend TRIEA and to incorporate the association's top 3 priorities:

1) CMSA supports a sustainable solution to ensure that terrorism insurance is available and more affordable. While CMSA supports a permanent solution, we believe that any extension should be longer than the previous extension and sustainable in length to provide stability and to avoid disruptions.

2) CMSA also would like to see the TRIA program improved to better incentivize the markets to insure NBCR exposures. In fact, we strongly support a "mandatory offer" regime for NBCR that includes different policyholder attachment points for "NBCR" coverage than for "conventional" coverage.

3) Finally, CMSA believes that Congress should eliminate the current distinction between "foreign" and "domestic" acts of terrorism. The market does not distinguish between these attacks, and such a change will avoid confusion and eliminate an unnecessary and unworkable distinction.

Status: Both the U.S. House of Representatives and U.S. Senate have passed different versions of legislation to extend the terrorism risk insurance program. The Senate legislation differs from its House counterpart in some important respects:

- The Senate bill provides for a 7-year extension, while the House bill is a 15-year extension;
- Both bills define acts of terrorism to include "domestic" acts;
- The House bill includes language that would require insurance carriers to "make available" coverage for nuclear, biological, chemical or radiological attack ("NBCR"), and provides for a far lower deductible and co-share for this risk; the Senate bill includes a study on NBCR by the President's Working Group on Financial Markets;
- The program "trigger" in the House bill is $50 million, while it is $100 million in the Senate bill; and
- The House bill includes "group life" coverage while the Senate bill does not.

House and Senate negotiators have begun conversations to reconcile the differences in the legislation and we are hopeful that a compromise can be reached in the upcoming weeks. CMSA will continues efforts to work with Congress to pass a sustainable solution for terrorism insurance before year-end.