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Terrorism Risk and Insurance

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In addition to the risk of natural disasters, the insurance industry faces the threat of terrorist attacks. Losses stemming from the destruction of the World Trade Center and other buildings by terrorists on September 11, 2001 totaled about $31.6 billion, including commercial liability and group life insurance claims—not adjusted for inflation—or $41.4 billion in 2011 dollars. About two thirds of these losses were paid for by reinsurers, companies that provide insurance for insurers.

Concerned about the limited availability of terrorism coverage in high-risk areas and its impact on the economy, Congress passed the Terrorism Risk Insurance Act (TRIA). The Act provides a temporary program that, in the event of major terrorist attack, allows the insurance industry and federal government to share losses according to a specific formula. TRIA was signed into law on November 26, 2002 and renewed again for two years in December 2005. Passage of TRIA enabled a market for terrorism insurance to begin to develop because the federal backstop effectively limits insurers' losses, greatly simplifying the underwriting process. TRIA was extended for another seven years to 2014 in December 2007. The new law is known as the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA) of 2007.

RECENT DEVELOPMENTS

- **TRIA Renewal:** With the expiration date fast approaching, legislation to extend TRIA was introduced in Congress on February 5 by Rep. Michael Grimm, (R.NY) and nine co-sponsors. The bill, HR 508, would extend TRIA in its current form for five years. TRIA is set to expire on December 31, 2014. Businesses that depend on coverage for terrorist acts say that TRIA has stabilized the marketplace and restored the capacity of the insurance industry to cover the risk for large portions of the U.S. economy.
- **Report by the President's Working Group on Market Conditions:** The President's Working Group on Financial Markets is required by TRIA to present periodic reports on the state of the terrorism insurance market to Congress. It made its first report in 2006. In its latest report, "Market Conditions for Terrorism Risk Insurance 2010," it says that the availability and affordability of terrorism risk insurance provided by the private sector has improved since 2006. However, it states, while capacity has increased overall, it is still limited in high-risk geographic locations, in particular for some commercial insurance policyholders in high-risk urban markets. The reason for the improvements since 2006, the working group suggests, is increased competition and better management of aggregate risk, which may be concentrated in certain urban locations. Take-up rates have remained basically flat at 60 percent since its last report although some policyholders may be purchasing more coverage. It notes, however, that there is great uncertainty among market participants over the ability to predict the frequency and cost of future terrorist attacks. It also said that comments sought from insurers for this report indicate that the current program, with its federal backstop, provides an incentive for insurers who otherwise might not have participated to underwrite terrorism coverage.
- **Availability and Affordability of Coverage:** The working group's findings in 2010 echo a previous study conducted by the U.S. Government Accountability Office (GAO) a year earlier. The GAO report said that while commercial property terrorism insurance seems widely available at rates policyholders believe is reasonable, certain types of policyholders may have more difficulty obtaining the coverage amounts they need at prices they view as acceptable. These policyholders are typically owners of high-value properties in urban areas where there is a high concentration of large buildings that are seen as potential terrorism targets. The GAO said that some insurers remain concerned about their exposure to terrorism losses and their efforts to minimize potential losses appear to be the primary reason some policyholders are facing challenges in obtaining coverage.

- There no consensus within the industry on whether TRIA should be modified, the GAO noted. However, it summarized several proposals, including lowering insurer deductibles in areas where an attack has taken place, allowing insurers to establish tax-deductible reserves for terrorist attacks and changing the Internal Revenue Code to encourage the issuance of catastrophe bonds, see Report Reinsurance and the Background section to this report. A study carried out in 2009 by AON, a large reinsurance broker, when the Obama administration first broached cuts in the budget for TRIA, found that if TRIA is changed or unfunded, 70 percent to 80 percent of the commercial property insurance market would revert to absolute exclusions.
- **Payment of TRIA Losses Above $100 Billion:** Former President Bush signed a long-term extension of the Terrorism Risk Insurance Act (TRIA) on December 20, 2007. The law included a provision that requires the U.S. Department of the Treasury to establish a process for the allocation of pro-rata payments in the event that terrorism-related insured losses exceed the federal government's annual $100 billion program cap. The law states that no insurer may be required to make any payment for insured losses in excess of its deductible and its share of insured losses.
- **Terrorism Insurance Market:** A 2011 report from Guy Carpenter, a reinsurance broker and Marsh subsidiary, suggests that rates for terrorism coverage are no longer dropping, as they were several years ago. Terrorism is just one type of catastrophe for which reinsurers allocate capital.

BACKGROUND

Prior to September 11, 2001, insurers provided terrorism coverage to their commercial insurance customers essentially free of charge because the chance of property damage from terrorist acts was considered remote. After September 11, insurers began to reassess the risk. For a while terrorism coverage was scarce. Reinsurers were unwilling to reinsure policies in urban areas perceived to be vulnerable to attack. Primary insurers filed requests with their state insurance departments for permission to exclude terrorism coverage from their commercial policies.

The Difficulty of Insuring Terrorism Risk: From an insurance viewpoint, terrorism risk is very different from the kind of risks typically insured. To be readily insurable, risks have to have certain characteristics.

The risk must be measurable. Insurers must be able to determine the possible or probable number of events (frequency) likely to result in claims and the maximum size or cost (severity) of these events. For example, insurers know from experience about how many car crashes to expect per 100,000 miles driven for any geographic area and what these crashes are likely to cost. As a result they can charge a premium equal to the risk they are assuming in issuing an auto insurance policy.

A large number of people or businesses must be exposed to the risk of loss but only a few must actually experience one so that the premiums of those that do not file claims can fund the losses of those who do.

Losses must be random as regards time, location and magnitude.

Insofar as acts of terrorism are intentional, terrorism risk doesn't have these characteristics. In addition, no one knows what the worst case scenario might be. There have been very few terrorist attacks, so there is little data on which to base estimates of future losses, either in terms of frequency or severity. Terrorism losses are also likely to be concentrated geographically, since terrorism is usually targeted to produce a significant economic or psychological impact. This leads to a situation known in the insurance industry as adverse selection, where only the people most at risk purchase coverage, the same people who are likely to file claims. Moreover, terrorism losses are never random. They are carefully planned and often coordinated.

Assessing Risk: To underwrite terrorism insurance—to decide whether to offer coverage and what price to charge—insurers must be able to quantify the risk: the likelihood of an event and the amount of damage it would cause. Increasingly, they are using sophisticated modeling tools to assess this risk. According to the modeling firm, AIR Worldwide, the way terrorism risk is measured is not much different from assessments of natural disaster risk, except that the data used for terrorism are more subject to uncertainty. It is easier to project the risk of damage in a particular location from an earthquake of a given intensity or a Category 5 hurricane than a terrorist attack because insurers have had so much more experience with natural disasters than with terrorist attacks and therefore the data to incorporate into models are readily available.

One problem insurers face is the accumulation of risk. They need to know not only the likelihood and extent of damage to a particular building but also the company's accumulated risk from insuring multiple buildings within a given geographical area, including the implications of fire following a terrorist attack. In addition, in the United States, workers compensation insurers face concentrations of risk from injuries to workers caused by terrorism attacks. Workers compensation policies provide coverage for loss of income and medical and rehabilitation treatment from "first dollar," that is without deductibles.

Extending the Terrorism Risk Insurance Act (TRIA): There is general agreement that TRIA has helped insurance companies provide terrorism coverage because the federal government's involvement offers a measure of certainty as to the maximum size of losses insurers would have to pay and allows them to plan for the future.

However, when the Act came up for renewal in 2005 and in 2007, there were some who believed that market forces should be allowed to deal with the problem.

Both the U.S. Government Accountability Office and the President's Working Group on Financial Markets published reports on terrorism insurance in September 2006. The two reports essentially supported the insurance industry in its evaluation of nuclear, biological, chemical and radiological (NBCR) risk—that it is uninsurable—but unlike the insurance industry, the President's Working Group said that the existence of TRIA has negatively affected the development of a more robust market for terrorism insurance, a point on which the industry disagrees. TRIA is the reason that coverage is available, insurers say. The structure of the program has encouraged the development of reinsurance for the layers of risk that insurers must bear themselves—deductible amounts and coinsurance—which in turn allows primary insurers to provide coverage. Without TRIA, there would be no private market for terrorism insurance.

Studies by various organizations have supported a temporary continuation of the program in some form, including the University of Pennsylvania's Wharton School, the RAND Corporation and the Organization of Economic Cooperation and Development (OECD), an organization of 30 member countries, many of which have addressed the risk of terrorism through a public/private partnership, see below. The OECD said in an analysis that financial markets have shown very little appetite for terrorism risk because of the enormity and unpredictability of the exposure. RAND argued not only that TRIA should be extended but also that Congress should act to increase the business community's purchase of terrorism insurance and lower its price. RAND also advocated mandatory coverage for some "vital systems," establishing an oversight board and increasing efforts to mitigate the risks.

The Terrorism Risk Insurance (Extension) Acts (TRIEA): Congress passed an extension of the 2002 Act at the end of December 2005. The legislation extending the Act to December 2007 greatly increased the portion of the loss insurers would pay in the event of a terrorist attack.

Below are summaries of the 2005 and 2007 extensions of the Act.

- The triggering event, the threshold for the program to go into effect, rose from $5 million under the original Act to $50 million after March 2006. In 2007 the trigger rose to $100 million and remained there under the latest extension. Only terrorist acts likely to produce total insurance industry losses above the threshold will result in payment of federal funds.
- Individual company deductibles—the amount an insurer must pay before the federal program kicks in—rose from 15 percent of commercial property/casualty insurance premiums in 2005 to 17.5 percent in 2006 and 20 percent in 2007 where they remain.
- Copayments, the amount insurers must pay above their individual deductibles or retentions, stayed the same in 2006 as in 2005—90 percent federal/10 percent insurer—but rose to 85 percent/15 percent in 2007.
- The industry as a whole must cover a certain amount of the losses through deductibles and copayments. This amount, known as the insurance marketplace aggregate retention, rose from $15 billion in 2005 and $25 billion in 2006 to $27.5 billion in 2007 where it remains. If, when all the computations have been made, the retention is found to be below the $27.5 billion threshold, the federal government can recoup the difference between the actual amount it paid and the required retention. The payment must come from a surcharge on commercial insurance policies not to exceed 3 percent of premium for insurance coverages that fall under the TRIEA program. If the industry is found to have retained an amount that exceeds the threshold, federal expenditures may be recouped for amounts in excess of the threshold at the discretion of the Secretary of the Treasury.

As outlined above, the 2007 extension of the law essentially maintained the prior TRIA structure but made several significant changes. In addition to extending the law for seven years rather than two as in previous renewals, the new law added domestic terrorism to acts defined as terrorism—the original legislation covered only acts committed by foreign terrorists. The longer renewal period reduces the uncertainty for long-term commercial projects that there will be coverage for damage caused by terrorism. The bill also provides for prorated payments by insurers when losses approach or exceed the $100 billion cap and requires periodic reports to Congress by the President's Working Group on Financial Markets.

The final bill did not include some provisions supported by lawmakers in the House. The House bill, which was much broader, had included the requirement that insurers make available coverage for nuclear, biological, chemical and radiological attacks (NBCR), a controversial provision that only some insurers supported. It also lowered the program's trigger to $50 million to make it less onerous for small insurers whose capital could be wiped out before losses reached the required $100 million. The House version also expanded coverage to include group life and farmowners insurance.

As under the 2005 legislation, the conventional attack deductible, or amount of losses an individual insurer must pay before the federal program kicks in, is 20 percent of commercial property/casualty insurance premiums. The industry's aggregate retention, or the maximum amount the entire industry must pay, remains at $27.5 billion. Copayments, the division of responsibility once the program is activated, are set at 85 percent federal/15 percent

insurer. The House bill had contained a sliding scale.

How TRIA Functions: The Terrorism Risk Insurance Act and its extensions authorized the creation of a federal reinsurance plan, which is triggered when insured terrorism losses exceed a predetermined amount. The program, a sharing of losses between the insurance industry and the federal government according to a preset formula—a type of reinsurance—has enabled the commercial insurance market to function, even though the threat of terrorism remains.

The law defines an act of terrorism under the 2007 amendment, to be covered by the federal program, an act of terrorism must be committed by individuals acting as part of an effort to influence the policy or conduct of the United States. The law also requires that the act be certified by the Secretary of the Treasury in concurrence with the Secretary of State and the Attorney General. Insurers do not pay the federal government for this reinsurance coverage that).” A single terrorist act must cause aggregate losses in excess of $5 million to be certified under TRIA.

Only commercial insurers and causes of losses specified in the underlying policies are covered. In addition to commercial lines insurers, insurers eligible for coverage under TRIA include residual market entities such as workers compensation pools, state-licensed captive insurers and risk retention groups, see report on captives. Personal lines insurance companies—those that sell auto and home insurance—and reinsurers are not covered. Neither are group life insurance losses. Most types of commercial insurance losses were covered under the original legislation, except some specialty coverages such as medical malpractice and crop insurance. Additional commercial insurance coverages were deleted under the 2005 extension including commercial auto insurance, professional liability except for directors and officers liability, surety, burglary and theft and farmowners multiperil, a coverage similar to homeowners. Directors and officers liability covers the top management of a company in the event of a lawsuit charging negligence or false statements.

In return for the federal backstop, commercial insurers must make terrorism coverage available and conspicuously state the premium charges; policyholders may, of course, reject the offer and choose to mitigate this class of risk in other ways. In offering terrorism coverage to their policyholders, commercial insurers must make it available on the same terms and conditions as they offer in their non-TRIA coverage.

After September 11, to minimize the likelihood of a wave of liability claims, Congress established the Federal Victims Compensation Act, which provided nearly $7 billion in payments to families of September 11 victims. In return, victims' families were required to give up the right to sue those they perceived as responsible parties. This provision is not part of TRIA or its extension.

Mandated Coverages/Exclusions: Insurance in the United States is state regulated. Regulators oversee solvency, market conduct and rates. In addition, they can require insurers to cover certain risks, if they perceive it to be in the public interest.

For example, on-the-job injuries under workers compensation insurance are covered whatever their cause. No state permits some types or causes of injury to be covered and others excluded. The only requirement is that they be incurred in the course of employment. Thus, injuries in the workplace resulting from terrorist attacks are always covered. Workers compensation insurance is a mandatory coverage in all states but Texas.

As with earthquakes where ruptured gas pipes and other similar damage can lead to fires, fire following a terrorist attack could cause huge losses. Following September 11, 2001, states began to review their coverage of fire following terrorism. The standard commercial fire policy (SFP) does not exclude fire following terrorism and, prior to 2003, the SFP did not permit this exclusion with the result that a policyholder who had rejected terrorism coverage under TRIA would still have coverage for fire following an act of terrorism. In five states, California, Maine, Missouri, Oregon and Wisconsin, this is still the case: there are no exceptions for terrorism. However, since 2003, some states have revised their SFP statutes to permit exclusions of fire following terrorism under certain circumstances. Thus, for a policyholder who has rejected terrorism coverage under TRIA, in these states there might be no coverage or limited coverage for fire resulting from an act of terrorism. Many states do not have a standard fire policy statute or have SFPs that unconditionally exclude fire following terrorism. In these states there is no stipulated coverage for fire following terrorism.

Managing Risk, Proposals for the Use of Dedicated Capital: One proposal that has been discussed for a number of years, even before September 11, in conjunction with meganatural disasters like Hurricane Katrina to help insurers better manage risk, is allowing insurers to accumulate tax-deferred catastrophe reserves.

Under current tax law, insurers can only put money aside in special funds or "reserves" to pay for claims if an event, such as a terrorist attack, has already occurred. Funds to pay for catastrophic losses come from an insurer's policyholders' surplus, which acts as a financial cushion in such situations. As a general rule, an insurer must maintain a certain level of capital and surplus to support the insurance policies it has issued. If it allows its surplus to drop significantly below industry standards and claims from a major terrorist attack create a drain on its assets, it may become insolvent. But if it increases its policyholders' surplus to fund an event that may only happen once in a

lifetime, it incurs opportunity costs—the loss of a chance to do something more economically productive with the money, such as generating additional business.

Various proposals for tax-deferred catastrophe reserves have been developed by insurers, the National Association of Insurance Commissioners and others. Some would make it mandatory for insurers to set aside pre-event reserves, while others would not. Some have a specific dollar target for total industry catastrophe reserves. However, each plan would allow tax deductions for amounts contributed to reserve accounts and then tax the funds withdrawn to pay claims.

Special Terrorism Insurance Programs in Other Countries: The United States is not the first country to establish a terrorism insurance program. Some countries created programs to cover terrorism after September 11 or earlier, following a terrorist attack on their own soil. Below are some examples.

Australia: Legislation was passed in 2003, under which terrorism exclusions in commercial policies are nullified once the government has declared that a terrorist incident has occurred. The legislation also created a reinsurance pool to cover insurance company losses from property, business interruption and third-party liability coverages, subject to a certain insurance company deductible, about 4 percent of property insurance premium. Insurers pay premiums into the pool which is back-stopped by the government. The program covers chemical and biological attacks but not nuclear attacks.

Austria: A terrorism pool has been in operation in Austria since 2002. The pool provides reinsurance protection against property damage and business interruption up to a certain limit. Insurers issue a separate terrorism policy and then transfer, or ”cede,” the business to the pool. Participation in the pool is voluntary but almost all insurers belong.

Belgium: Under a new law that went into effect in February 2008, coverage is available up to 1 billion euros, an amount that will be adjusted annually to keep pace with inflation. Participants in the Fund will pay the first EUR 700 million with the government paying the remainder up to the limit. Insurers will retain a part of the EUR 700 million, according to market share, and reinsure the rest. A committee that includes insurers will decide whether an event meets the definition of terrorism.

France: Under a law passed in 1986, terrorism must be covered. Since 2002, terrorism has been covered by a reinsurance pool to which terrorism risk above a certain retention level is transferred. Insurers pay premiums to the pool. They are divided up among the participants in each of the four different layers of risk with the government-owned Caisse Central de Reassurance receiving 10 percent of premiums for providing the top layer of unlimited coverage. The government pays for all terrorist claims that exceed a specific amount. Premiums are set according to the insured amount, not the riskiness of the location.

Germany: Private insurers cede commercial insurance coverage written above a certain limit to a pool set up in 2002. The pool, in turn, cedes all its risk to other insurance companies, which act as reinsurers. The ultimate layer of protection, for which insurers pay reinsurance premiums, is provided by the government. The program was extended for two years at the end of 2007 and after 2009 will probably be renewed again but for a lower amount, Germany's Finance Minister said in making the announcement of the extension. The government pays claims above an aggregate amount.

Netherlands: A terrorism reinsurance company was created to reinsure its member companies who retain a percentage of the risk. Coverage is limited per member and in the aggregate. Life and property/casualty insurers participate in the pool, as well as health insurers.

Spain: Beginning in 1941, Spain has had a government-sponsored but privately managed pool which provides coverage against injury, property damage and business interruption due to catastrophes, natural and man-made. Personal lines as well as commercial are covered. Coverage for extraordinary risks is mandatory. The original need for terrorist coverage stemmed from acts of violence carried out by the Basque separatist movement, which has been active in Spain for many decades. The 2004 Islamic terrorist bomb attacks in Madrid exacerbated the risk. Private insurers may provide catastrophe coverage but they are still required to make payments to the pool, which is backed by an unlimited guarantee from the government.

Switzerland: Beginning in 2003, insurers can cede all property risk insured for a sum above a certain amount to a reinsurance facility.

United Kingdom: The government formed a mutual reinsurance pool for terrorist coverage in 1993, following acts of terrorism by the Irish Republican Army. Insurance companies pay premiums at rates set by the pool. There are two geographic zones, one for major cities, with an adjustment for a "target risk," and the other for the remainder of the country. The primary insurer pays the entire claim for terrorist damage but is reimbursed by the pool for losses in excess of a certain amount per event and per year. This is based on its share of the total market. The maximum industry retention increases annually per event and per year. Following the World Trade Center disaster, coverage was extended to cover all risks, except war, including nuclear and biological contamination, aircraft impact and

flooding, if caused by terrorist attacks. The government acts as the reinsurer of last resort, guaranteeing payments above the industry retention.

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