Financial Services and E-Commerce

An Update on Terrorism Risk Insurance

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On November 26, 2002, the President signed into law the Terrorism Risk Insurance Act of 2002 (TRIA).[1] The Act became effective immediately. It established a temporary Terrorism Risk Insurance Program ("Program") of shared public and private compensation for insured commercial property and casualty losses resulting from an act of terrorism. The Program, administered by the Secretary to the Treasury, was due to terminate on December 31, 2005. However, in December 2005, Congress passed the Terrorism Risk Insurance Extension Act of 2005 (TRIEA), extending TRIA for an additional two years.[2] It also made other significant changes to TRIA, discussed below.

Under TRIA, insured losses are covered if they result from an act of terrorism (including an act of war in the case of workers' compensation); covered, that is, by property and casualty insurance issued by an insurer (if the loss occurs within the U.S.); or to a U.S. air carrier, a U.S. flagged vessel (or vessel based principally in the U.S., on which U.S. income tax is paid and whose insurance coverage is subject to U.S. regulation), or at the premises of any U.S. mission.

TRIA enacted a Terrorism Insurance Program which provides federal compensation for insured losses arising from acts of terrorism. The federal compensation provided in the original Act was equal to 90% of the amount by which such insured losses exceed the applicable insurer deductible.[3] Participation by insurers is mandatory. In 2007, the amount of federal compensation provided was reduced to 85%.[4]

The act of terrorism must be certified by the Secretary to the Treasury. It must be a violent act or an act that is dangerous to human life, property, or infrastructure and must have resulted in damage within the U.S. or outside in the case of an air carrier, vessel or U.S. mission. It must have been committed by one or more individuals acting on behalf of a foreign person or interest as part of an effort to coerce the U.S. population or to influence the policy or affect the U.S. government's conduct by coercion. Property and casualty losses resulting from the Act must, in the aggregate, exceed $5 million.[5]

While TRIEA did not amend the definition of "act of terrorism," it did introduce a "Program Trigger" on March 31, 2006. The Program Trigger mandates that no compensation will be payable unless aggregate insurance industry losses resulting from a certified act of terrorism exceed $50 million in the remainder of 2006 and $100 million in 2007.[6]

The Department of Treasury's (DoT) Interim Guidance released in December 2005 says the DoT will determine whether the Program Trigger has been met through a similar process to that for determining aggregate insured loss amounts. Once the Program Trigger amount is exceeded, Treasury will notify insurers through a press release notice in the Federal Register and postings on its website.

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TRIEA revised the definition of "Insurer Deductible" that adds new Program Years 4 and 5 to the definition. The insurer deductible is set as the value of an insurer's direct earned premium for commercial property and casualty insurance over the immediately preceding calendar year multiplied by 17.5% for 2006 and 20% for 2007.

The revised definition of "Property and Casualty Insurance" found in TRIEA excluded commercial automobile, burglary and theft, surety, professional liability, and farm owners multi-peril. While the revised definition excluded professional liability insurance, it explicitly retained directors' and officers' liability insurance.

For purposes of recouping the federal share of compensation under the Act, the "insurance marketplace aggregate retention amount" for the two additional years of the Program is increased from the level in 2005. For 2006 the "insurance marketplace aggregate retention amount" is established as the lesser of $25 billion and the aggregate amount, for all insurers, of insured losses during 2006. The "insurance marketplace aggregate retention amount" for 2007 is the lesser of $27.5 billion and the aggregate amount, for all insurers, of insured losses during 2007.

GAO Report on Terrorism Insurance

In September 2006, the U.S. Government Accountability Office (GAO) released a report entitled "Terrorism Insurance: Measuring and Predicting Losses from Unconventional Weapons is Difficult, but Some Industry Exposure Exists."[7] The report focuses on the exposures presented by "unconventional" or Nuclear, Biological, Chemical, and Radiological (NBCR) weapons, with little mention of more "conventional" or non-NBCR weapons. The key conclusion of the report is that, "given the challenges faced by insurers in providing coverage for, and pricing NBCR risks, any purely market-driven expansion of coverage is highly unlikely in the foreseeable future." While the GAO makes no recommendations, it created a strong argument for Congress to act before the expiration of the Terrorism Risk Insurance Act (TRIA) in 2007. The report makes the case that Congress needs to act to extend or replace TRIA, since NBCR is uninsurable. However, the report does not address the fundamental un-insurability of non-NBCR losses as well.

President's Working Group

Also in September 2006, the President's Working Group on Financial Markets released its report concerning the long-term availability and affordability of terrorism risk insurance. The report finds that, in general, any evaluation of the potential degree of long-term development of the terrorism risk insurance market is difficult.

TRIEA required that the Working Group perform an analysis regarding the long-term availability and affordability of insurance for terrorism risk, and to report to Congress by September 30, 2006. The Working Group posed specific questions, and solicited comments, including empirical data and other information in support of answers to these questions, where appropriate and available. It is chaired by the Secretary of the Treasury, and also includes the Chairmen of the Federal Reserve Board, Securities and Exchange Commission, and Commodity Futures Trading Commission.

The report finds little potential for future private market development for NBCR risks in particular. While the report makes no legislative recommendation, it does generate a strong argument for Congress to act before the expiration of the TRIA on December 31, 2007.

The report contains two significant findings about the ability of the private market, on its own, to underwrite terrorism risks. The report states:

> The greater uncertainty associated with predicting the frequency of terrorist attacks along with what appears to be a general unwillingness of some insurance policyholders to purchase terrorism risk insurance coverage makes any evaluation of the potential degree of long-term development of the terrorism risk insurance market somewhat difficult.
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> In contrast to the overall market for terrorism risk insurance, there has been little development in the terrorism risk insurance market for CNBR (chemical, nuclear, biological, radiological) risks since September 11. Given that insurance companies have historically excluded coverage for these types of losses—even if not caused by terrorism—there may be little potential for future market development.

Nevertheless, the Working Group report does state that the "presence of subsidized federal reinsurance through TRIA appears to negatively affect the emergence of private reinsurance capacity because it dilutes demand for private sector reinsurance," an argument first articulated in a report issued in 2005 by the Treasury Department.

Insurer Perspective

Insurers are working to help Congress develop a market-based program that protects the economy against the risk of terrorist attack, promotes the development of robust private markets to assume more of this risk over time, and reduces taxpayer exposure to this risk over time. Insurers contend that capital is the key to terrorism insurance availability, and that continuing federal involvement and market freedoms are crucial to attracting additional capital.

Insurers seek a policy solution that adheres to three key propositions:

> The policy cannot discriminate on the basis of who is attacked. Any terrorist attack is an attack on all, and must be treated as such.
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> The policy cannot discriminate in terms of the form of attack. Both the GAO Report and the PWG Report made it clear that nuclear, biological, chemical, and radiological (NBCR) risks can only be covered with a federal backstop. The same can be said for any attack that results in this level of devastation.
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> The policy needs to refrain from picking winners and losers, when it comes to who can provide insurance. On that point, a competitive private market depends.

A reinsurance industry that supports public–private partnership is necessary to help stabilize the commercial insurance markets that underpin a free-market economy. Working with their client primary companies to manage their substantial retained exposure under TRIA, reinsurers have been willing to put limited capital at risk to manage terror-related losses. Reinsurers typically seek to manage the risk by offering terror coverage in a stand-alone contract rather than within a traditional all-peril catastrophe treaty contract, especially for insurers writing a national portfolio. Some regional carriers, with exposures limited to rural or suburban areas far from target risk cities and business centers, have secured terrorism coverage within their standard reinsurance programs, usually with some limitations as to the nature of the subject risk or size of subject event.

Reinsurers are only able to provide limited capacity for terrorism because the potential losses would place these companies at risk of insolvency. Reinsurers' capital is necessary to support all outstanding underwriting commitments they face, including natural disasters, terrorism, workers' compensation and other casualty coverages.

Some have suggested the possibility of the capital markets assuming terrorism risk. Catastrophe bonds are a known mechanism for using financial markets to absorb and spread natural hazards risk. However, terrorism presents a much greater underwriting and pricing challenge than natural catastrophe risk to the insurance and reinsurance industry as well as to those issuing and investing in catastrophe bonds. There is no reason to believe terrorism bonds are likely to be a significant provider of terrorism coverage in the foreseeable future. The capital markets face the same problems as insurers: inability to assess frequency of attack, a lack of predictive experience, correlation of loss to other exposures such as a stock market decline, and potentially devastating financial loss.

CONCLUSION

Insurance consumers and the companies they rely on to provide security from the potentially devastating financial losses of a terrorist attack are beginning to face a growing level of uncertainty surrounding the December 31, 2007 expiration of the Terrorism Risk Insurance Act (TRIA). Terrorist attacks are uninsurable because it is impossible to predict how frequently they will occur, where they will happen, or what form they will take. By establishing a high level financial backstop for terrorism losses, Congress has transformed an uninsurable risk into an insurable one. A review of market conditions in the wake of the 9/11 attacks demonstrated that a private market for terrorism insurance simply did not exist.

The economic consequences are very real. Unless high level backing for a public-private terrorism insurance partnership is continued, there could be significant market disruptions that will shrink the availability of terrorism insurance or dramatically increase the price of such coverage for buyers.

Congressional leaders have indicated that they intend to reduce the federal government's involvement in terrorism risk and increase private market involvement in solving this problem. A growing bipartisan consensus is emerging in the Congress that is committed to achieving a long-term, market-based solution with a continuing role for the federal government. Over time, the private sector can assume a greater portion of the responsibility, but only with a public-private partnership is there any hope for terrorist insurance to be available and affordable.

TRIA is an important part of the program in the war on terrorism. It does not require an expensive federal bureaucracy to administer, it transfers much of the risk to private insurers, and it has stimulated economic growth by allowing millions of businesses to protect themselves from the financial devastation of a future terrorist attack. The impending expiration of the Act in December 2007 may mean a gradual shift of more responsibility for terrorism losses to the private market while at the same time following the example of more than a dozen other nations and making TRIA permanent.

Endnotes

1 Pub. L. 107–297.

2 Pub. L. 109-144.

3 (s. 103(e)(1)).

4 (s. 4).

5 (s. 102(1)).

6 (s.6).

7 GAO-06-1081.