Terrorism Coverage: Economic Security Is Important Too

Since the terrorist attacks of Sept. 11, our country has made enormous investments in physical security. We now have a Department of Homeland Security, a Transportation Security Administration screening airports, stepped-up immigration controls, inspections of container ships, private security guards at the entrances to large buildings, and a host of other expensive and invasive measures.

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Unfortunately, our country paid far less attention to its financial security, specifically in terms of its insurance systems' and/or businesses' ability to withstand the financial losses associated with another terrorist event.

That situation changed in November 2002. After a year of delay, largely due to partisan bickering over tort restrictions, the Congress passed and the President signed H.R. 3210, the Terrorism Risk Insurance Act of 2002.

The legislation is historic for many reasons:

- It represents a major expansion of the federal government's role in the property and casualty insurance marketplace.
- It acknowledges that the federal government has a unique role to play in raising the funds needed to cover terrorist losses, a conclusion that has been reached by other countries facing terrorist threats, like Israel and Great Britain.
- It provides a framework of a public/private partnership in terms of sharing losses.
- It relies on the proven ability of the private sector to efficiently adjust claims.

Why H.R. 3210 Was Necessary

Regardless of whether a bill like H.R. 3210 was enacted, the federal government would have been deeply involved in the economic fallout of another terrorist attack. Passage of this act lays out an orderly process for that involvement, while drawing on the strengths of the private sector, particularly in the area of claims settlement. Advantages include:

- Liabilities can be determined based on insurance contracts, instead of ad-hoc appropriations.
- Funds can be distributed through the proven insurer claims settlement mechanism.
- The existence of the program is likely to calm financial markets after the next event. Without it, it is a virtual certainty that many insurers would have abruptly left the market after a huge event, regardless of whether regulators approved exclusions for terrorism coverage.
- Solvency will be strengthened, as many insurers would otherwise have faced crippling losses, either due to their inability to predict future losses, or regulatory restrictions on terrorism exclusions.
- Businesses, and the banks that loan them money, have been saved from de-facto self-insurance on large risks. This exposed the economic system to significant business failures or loan defaults.

Terrorism is virtually uninsurable in the private sector due three factors I refer to as the "actuarial axis of uncertainty": there is no credible historical data on terrorism losses; lacking data, we cannot model the acts of madmen with any degree of certainty; and the

The Terrorism Risk Insurance Act at a Glance

(Based on material from the Insurance Information Institute)

- An event has to cause at least $5 million in losses to be certified as an act of terrorism.
- Insurer participation is mandatory; insureds may opt-out.
- Participating insurer responsibility:
  - a deductible – based on a percentage of subject direct earned premiums:
    - 2003 – 7%
    - 2004 – 10%
    - 2005 – 15%
  - For losses above the deductible, the [illegible] 90%, while the insurer [illegible]
- If the federal government pays for [illegible] year, the Treasury Secretary [illegible] between total industry [illegible] deductibles, plus the [illegible] deductibles) and the [illegible]
  - $10 billion [illegible]
  - $12.5 billion [illegible]
  - $15 billion [illegible]

size of the potential losses is so great that they cannot be absorbed in the premium base as a "contingency" without a "risk load" that could render the coverage unaffordable.

This is why the unregulated reinsurance industry, which is able to insure the knees of college athletes or exotic art collections, has almost universally excluded coverage for all commercial lines or personal lines "nuclear, biological, or chemical" (NBC) terrorism losses. While there are attempts at modeling terrorist losses, and some private sector coverage is available through reinsurance, there is clearly nowhere near the supply of coverage to meet the need, and no assurance that such coverage would be available following the next event.

What the Act Does

When the Act was signed into law, all terrorism exclusions in primary private insurance contracts were voided. Insurers are required to participate in the program and to make terrorism coverage available if they write covered commercial lines. Insurers are allowed to charge a premium for this coverage, subject to after-the-fact review by state regulators.

The federal government will cover 90 percent of losses above a deductible of seven percent of 2002 Subject Direct Earned Premium for covered lines in 2003, up to a limit of $100 billion. Insurers are required to notify customers within 90 days of the signing of the act [expected in late February] as to what coverage they have for terrorism and what premium will be charged if the insured elects to keep terrorism coverage.

To characterize government participation in terrorism losses that the industry was absorbing virtually free of charge as a "handout" is simply wrong. Insurance is not welfare. Private sector coverage cannot simply be given away because insurers have a lot of capital and consumers need coverage.

What this Act Means for Florida

At first glance, it may seem that Florida did not need this act as much as other states, since its regulators had not approved terrorism exclusions.

However, insurers were being required to cover huge exposures for which they collected little or no premium and for which there was little or no reinsurance, which was not a sustainable situation. Already, many insurers had reacted to the restrictions on exclusions by non-renewing entire policies (theft, liability, wind, etc.), forcing risks into the surplus lines market, where terrorism exclusions could be imposed without regulatory interference.

However, Florida's regulators' gamble — that most insurers would continue to absorb the risk until the federal

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government acted — paid off. A federal program was enacted, no solvency threatening major event occurred, and the majority of insureds were provided with coverage in the interim.

Already, the federal act is having an effect on the ability of Florida businesses to get terrorism coverage. According to press reports, many large commercial insureds are seeing big savings in the cost of coverage, which had become difficult to obtain in the admitted market and expensive in the surplus lines market.

Within the next several weeks, insureds will be getting notices explaining how individual insurers plan to cover terrorism and whether they will charge an additional premium for it. At this time, it is unclear how Florida's regulators will react to premium charges for terrorism coverage. Regardless, agents need to be prepared for numerous questions on this subject.

While there are attempts at modeling terrorist losses, and some private sector coverage is available through reinsurance, there is clearly nowhere near the supply of coverage to meet the need, and no assurance that such coverage would be available following the next event.

Overall, however, the act will result in less expensive and more available coverage in the voluntary market. The coverage that is offered will be of higher quality, as losses will be backed by the federal government.

Most importantly, Florida will be better able to protect premium dollars collected here from terrorism losses. Since the federal government has yet to enact a needed Natural Disaster Act a decade after Hurricane Andrew, Florida needs to conserve its scarce premium dollars for hurricanes.

Is H.R. 3210 a Taxpayer Bailout of Insurers?

The Consumer Federation of America (CFA) claimed that H.R. 3210 means that "insurance companies would receive a taxpayer-financed hand out." They also claimed that, "Insurance companies can afford to pay far more. The property/casualty insurance business is booming."

The insurance industry incurred $40.2 billion in losses on Sept.11, according to the Insurance Information Institute (III). The industry had collected almost no premium for this exposure, as terrorism losses of this magnitude had never been part of the experience base upon which rates were set. After Sept.11, market rates did increase, but this was generally due to cyclical economic factors and not an explicit recognition of potential terrorism exposure.

To characterize government participation in terrorism losses that the industry was absorbing virtually free of charge as a "handout" is simply wrong. Insurance is not welfare. Private sector coverage cannot simply be given away because insurers have a lot of capital and consumers need coverage.

The act removes an impediment to the capital growth that will be necessary to preserve availability of coverage in Florida. According to the III, "...the [insurance industry's] four-to-five percent return [on equity] expected in 2002—while a marked improvement over 2001's worst-ever performance—is still dreary, even when compared to today's recession-reduced return-on-earnings expectations for American industries, generally of about 10 percent." This hardly qualifies as "booming," and underscores the urgency of reducing the industry's exposure to huge terrorism losses if it is to attract the capital it needs to prudently underwrite the other risks it assumes, like hurricane.

If H.R. 3210 is a handout to anyone, it is to businesses and the banks that loan them money, which would face ruinous losses and long-term disruption in coverage without it.

Much Work To Be Done

H.R. 3210 is a good start toward building a sustainable long-term financing mechanism for terrorism losses. However, much work is yet to be done. The act has extremely tight time frames for implementation for both the Treasury and insurers, and some confusion is inevitable. Officials at the Treasury Department are working to get the program set up and to acquaint themselves with the nuances of the insurance industry. As an example, the act is not completely clear on exactly which policies it covers. Is a Farm written on a Farm Fire form or a Dwelling Fire policy covering six rental units a "commercial risk?"

In the long term, there are two major issues that need to be addressed:

- *The act sunsets in 2005.* However, it is unlikely that we will have rid the world of Al-Qaeda and their like by then, and it is difficult to see how the insurance industry can fill a $100 billion coverage gap at affordable rates, even if it were possible to reliably price and quantify the exposure.
- *The act fails to address the issue of terrorist exposure on Personal Lines policies,* except for a requirement for the Secretary of the Treasury to report to Congress on the subject by August 26.

Just because the last attack targeted a large commercial building, there is no guarantee that the next one will. There is a serious exposure to NBC losses in personal lines, as evidenced by the fact that in Great Britain, Household (Homeowners) policies provide no coverage for NBC losses, despite the fact that rates are largely unregulated.

As was the case in commercial lines, U.S. insurers are collecting little or no premium and have little or no reinsurance coverage to back them up for personal lines terrorism losses, in either property or automobile physical damage. Let's hope that our government wakes up to this problem before we revisit the lesson we learned so painfully when the warning of Hurricane Hugo was ignored and the industry got blindsided by Hurricane Andrew. ◊