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Extending Terrorism Insurance

The case is strong for maintaining a federal backstop in a market too risky for the private sector alone

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FINDINGS

» The Terrorism Risk Insurance Act (TRIA) is scheduled to expire at the end of 2014. The insurance industry is unanimous in arguing that it should be extended. The industry and many experts believe insurance coverage for acts of terrorism would be less available without TRIA, potentially curtailing construction of high-profile commercial projects.

» After 9/11, the supply of terrorism insurance policies virtually disappeared. After TRIA was enacted, commercial take-up rates rose to more than 60 percent in 2012 from 27 percent in 2003. Acts of terrorism remain almost impossible to build into traditional insurer pricing models because they are deliberate and not random events.

» Arguments by some critics of TRIA that the private market is ready and able to step in to fill the void have almost no academic support.

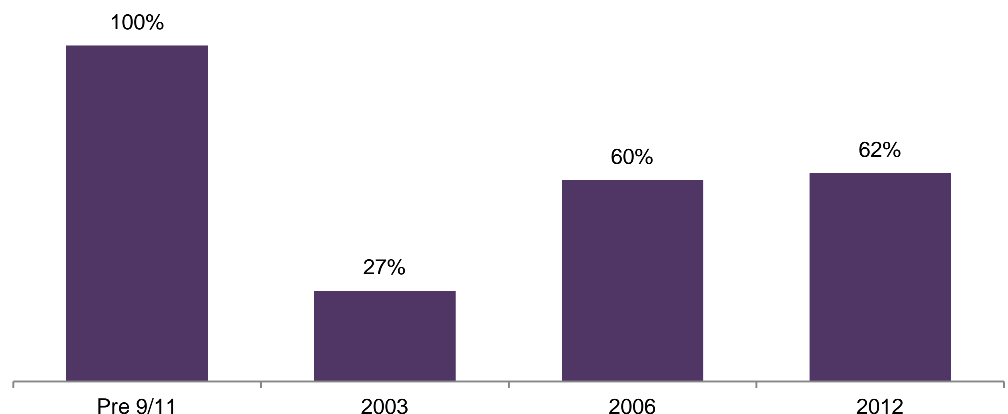
» This analysis concludes that TRIA, like bank deposit insurance, is a government program that addresses a permanent failing of the private market to provide necessary coverage.

WHAT'S AHEAD

Three House bills — H.R. 508, H.R 1945 and H.R. 2146 — all seek to extend the program. H.R. 508 and H.R. 2146 have been referred to House Subcommittee on Cybersecurity, Infrastructure Protection and Security Technologies.

Commercial Take-Up Rates for Terrorism Insurance

The Terrorism Risk Insurance Act of 2002 became law on Nov. 26, 2002



Source: Property Claim Services, Insurance Information Institute, testimony by Erwann O. Michel-Kerjan to the House Committee on Financial Services (see endnote 9)

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INTRODUCTION

The Terrorism Risk Insurance Act of 2002 was first extended in 2007, and is now scheduled to expire in 2014. On Feb. 5, Rep. Michael Grimm (R-N.Y.) introduced the "Terrorism Risk Insurance Act of 2002 Reauthorization Act of 2013" (H.R. 508), which would extend the terrorism risk insurance program (TRIA) for another five years, to 2019[1]. In addition, recoupment of any payments made under the program would need to be recovered by 2024, rather than 2017 as currently written into the law. Another bill, "The Fostering Resilience to Terrorism Act of 2013" (H.R. 1945),[2] would extend the program for 10 years. A third bill, the "Terrorism Risk Insurance Program Reauthorization Act of 2013" (H.R. 2146),[3] would extend the program for 10 years and also require the president's Working Group on Financial Markets to file reports on market conditions in 2017, 2020 and 2023.

The main provisions of the current program are:

1. Insurers are required to make terrorism coverage available to commercial policyholders, although policyholders are not required to buy it. The coverage can form part of a more general property/casualty insurance contract or can be standalone.
2. For an act certified as terrorism by the Secretary of the Treasury, Secretary of State and Attorney General, government coverage begins for losses exceeding $100 million.
3. In the event of a claim, private insurers pay out 20 percent of their direct earned premiums from TRIA-specified policies. According to the National Association of Insurance Commissioners, direct earned premiums specified in TRIA totaled $34 billion in 2011.
4. Once the $100 million event-specific threshold is passed and the deductible is paid, the government pays 85 percent of the losses incurred by each insurer. The insurer's total liability is therefore the 20 percent deductible plus 15 percent of the loss in excess of the deductible.
5. If the total loss doesn't exceed $100 billion, the government will recoup 133 percent of its payout through an after-the-fact assessment on the property and casualty insurance industry.
6. Since TRIA was enacted in 2002, no event has triggered a government payout.

For a detailed overview of the program, see papers published by the Congressional Research Service[4] and the President's Working Group on Financial Markets.[5]

PERMANENT MARKET FAILURE?

During the past few years, lawmakers have been looking for ways to lower taxpayer exposure to the financial sector. Dodd-Frank, for instance, was written with the expressed aim of reducing the chances of government bail-outs for banks that were previously considered too big to fail.[6]

Congress has chosen where possible to terminate specific guarantee programs set up during the financial crisis. The Treasury's money market guarantee program was allowed to expire on Sept. 18, 2009, one year after it had been set up. And in January of this year, the Transaction Account Guarantee (TAG) program came to an end. This special program, also created at the height of the financial crisis, provided unlimited deposit insurance on transaction deposit accounts. With its expiration, deposit insurance on transaction accounts, like other deposit accounts, is limited to $250,000 per person per account.

The decision by Congress to terminate both emergency programs has not, so far, caused any significant issues for either industry. While emergency government support is sometimes required financial institutions and their customers generally should look to themselves, and not to the government, for surety. This of course doesn't mean that the programs' expirations were uncontested. In the case of TAG, a coalition of large depositors and small banks attempted, but failed, to have the program extended.[7]

While the mood in Washington seems to be that any special financial crisis-related guarantees should be terminated, no one seems to be contesting the continuation of a base level of deposit insurance. It is generally recognized that the Federal Deposit Insurance Corporation and its guarantees (backed by fees paid by the banking industry) has brought stability to deposit-taking banking in the U.S. since its creation in 1933.

In deciding whether to extend TRIA after it expires in 2014, Congress will debate whether the program is similar in nature to emergency programs such as TAG and the money market fund guarantee that were judged to be no longer needed after the financial crisis passed, or whether TRIA is more like deposit insurance that should be maintained in good times and bad. If the latter is the case, the most appropriate response is to extend TRIA and/or consider ways to make it permanent.

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Put another way, the question revolves around whether the private market is able to provide necessary insurance coverage. In the case of the FDIC, the private market was found wanting. Congress needs to consider whether the same can be said of terrorism insurance.

ARGUMENTS FOR EXTENDING TRIA

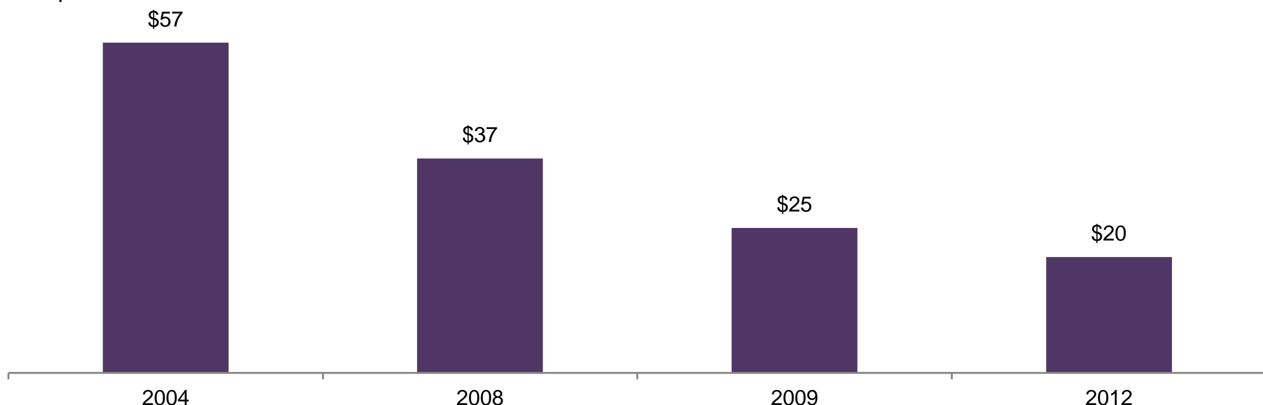
Both this section and the next one summarize arguments in favor and against extending TRIA that were advanced during a hearing of the House Financial Services Committee, held on Sept. 11, 2012.[8]

1. TRIA appears to have been a great success. Prior to 9/11, U.S. insurers bundled terrorist coverage into their general property/casualty insurance policies without an additional premium. In retrospect, this reflected a major risk miscalculation on the part of the industry. Prior to 9/11, risk was shared between primary insurers and reinsurers (predominantly European). After 9/11, reinsurers ended coverage for terrorist acts. Soon after, primary insurers did the same; leaving very little available coverage. As the chart on the front page shows, policyholder coverage for terrorism has risen substantially since TRIA was enacted. According to data from Marsh Inc. and Aon Plc., commercial take-up rates were 27 percent in 2003, more than doubling to 60 percent by 2006 and remaining stable since then.[9]
2. Without TRIA the private market for terrorism insurance coverage probably would shrink, and where coverage was offered it could be much more expensive. The reasons relate both to the nature of insurance and the nature of terrorist attacks. Insurance works on the basis of four main principles: (1) there are enough events (think of fender-benders) to make losses reasonably predictable; (2) losses can be estimated and, in particular, a maximum possible estimate can be made; (3) losses happen by chance, so the events are random and not purposeful; and (4) events are not highly correlated or catastrophic so as to cause huge payouts well in excess of premiums collected and reinvested earnings.

   Terrorism fails on all of these criteria. Unlike weather-caused disasters, for instance, terrorist attacks are unique events whose likelihood and costs are almost impossible to predict or model. Events don't happen by chance and they are potentially catastrophic. And, unlike earthquakes (which the federal government refused to provide a backstop to in the early 1990s, after much lobbying by industry), home-owners and builder-owners cannot take meaningful steps to reduce the risk of damage.

   As a result, it is almost impossible to price insurance premiums properly. While it was reported in 2010 in the Presidents Working Group Report that there had been significant advances in terms of data collection and modeling, such advances still fell far short of what would be required for rational pricing.[10] Indeed, it is questionable whether a model can ever be developed that would account for the erratic and purposeful behavior of terrorists.

Median Premium Rate for Medium- and Large-Sized Companies
Premium per million dollars insured



Source: Property Claim Services, Insurance Information Institute, testimony by Erwann O. Michel-Kerjan to the House Committee on Financial Services (see endnote 9)

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3. As the chart above shows, prices for coverage have fallen since TRIA was enacted. This may reflect the fact that there has been no repeat of an attack on the scale of 9/11 (the only terrorist attack within the U.S. has been the 2013 Boston Marathon). However, it also probably reflects that TRIA has successfully created a functioning marketplace for terrorism insurance and that competition has brought the cost of insurance down.

4. The expiration of TRIA would probably lead to a shrinking of available coverage for terrorism. Aon estimates that 70 percent to 80 percent of the market would encounter terrorism exclusions if the program were discontinued.[11] This may mean that companies required to have such coverage (such as construction companies operating in Manhattan and other dense urban areas) would have to cancel investment projects.

   The potential downside effect on the economy of not having terrorism insurance coverage was one of the key motivations for TRIA in 2002. The Council of Economic Advisers found that in the absence of a well-functioning terrorism insurance market, 300,000 jobs were lost due to deferred construction investment.[12] According to the Real Estate Roundtable, during the 14-month period between 9/11 and the passage of TRIA, about $15 billion in real-estate transactions were delayed or cancelled.[13] Available evidence seems to suggest that prior to the extension of TRIA in 2007 the market for terrorism insurance had already begun to shrink.[14]

5. Letting TRIA expire may not lessen the government's potential liability arising from future acts of terrorism. As discussed above, the expiration of TRIA probably would lead mainstream insurers to withdraw from the market. Second-tier insurers could step into the void — without the requisite policyholder surplus (and capital) to cover a loss from a major terrorist attack — and sell high-value insurance based on a gamble that no major terrorist event will occur. Were such an event to take place, and these insurers were unable to cover losses, government would probably would feel duty bound, especially in the emotional aftermath of a terrorist attack, to spend taxpayer funds to cover the shortfall.

6. TRIA is fiscally responsible. Any payouts made by the federal government under the TRIA program are recouped from the industry as a whole. Therefore the contingent liability created by TRIA is not permanent but relates to the timing of cash flows. This makes it similar to the deposit insurance fund, which had to borrow from the Treasury during the crisis. These loans have now been repaid through assessments on FDIC member banks and thrifts. That said, it should be noted that, save for the effects of the financial crisis, the deposit insurance fund is funded *ex ante* by the industry, while TRIA is funded *ex post*; that is, government payouts are recouped from the industry after the event.

7. Other countries that have faced terrorist attacks — Israel, Spain, France, the U.K. and Germany — have opted for terrorism insurance that involves some form of government participation. Governments in these countries concluded that the private market alone would not be able to provide the coverage required by commerce.

ARGUMENTS AGAINST EXTENDING TRIA

During the House Financial Services Committee hearing only one of the 12 witnesses, David C. John, a senior research fellow at the Heritage Foundation, argued against the extension of TRIA. The arguments in this section generally summarize his testimony.

1. The continued existence of TRIA is preventing the development of a private terrorism insurance market. With enough lead time, insurers could develop appropriate models that would lead to rational pricing. By the end of 2014, the industry would have more than 12 years of data to work with.

2. TRIA contributes to an underpricing of terrorism insurance because the government provides a backstop and the industry therefore collects premiums without facing the true value of potential losses. As a result, those buying the insurance don't have sufficient incentives to reduce their exposure to terrorism risk.

   An example of this is the federal flood insurance program and the Florida hurricane insurance program. Both demonstrate that political pressure can lead to lower and lower premiums, which can end up being well below the actual cost, thus subsidizing risky behavior.

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Congress should begin immediately to start the partial phase-out of TRIA. For example the deductible paid by insurers should increase, the threshold for payout should be increased and acts of domestic terrorism should be removed from coverage. Phasing out TRIA now would give the industry enough time to meet customer needs and would make it clear that there is to be no reprieve for the program.

3. Increased coverage and falling prices reflect that a proper market is developing for terrorism insurance, even as TRIA continues to exist. As such, there is no reason to assume that insurers cannot build models that price risk appropriately. That these models are less developed than for other catastrophic events may not reflect the nature of the risk, but instead reflect that TRIA is stunting full development of the market.

4. It is wrong that taxpayers should have continued exposure to insurance losses on private property. If a terrorist attack were to cause greater than $100 billion in damages, TRIA leaves the issue of repayment to the discretion of government. And regardless of the size of the loss, there remains a risk that the private insurers will be unable to repay the government.

CONCLUSION

The weight of professional and academic opinion is clearly on the side of extending TRIA. While coverage has improved, the argument that a private market can provide sufficient terrorism coverage doesn't have wide academic support. Based on past experience, there is no reason to assume that reinsurers will re-enter the market if the TRIA program expires, and every reason to assume that the availability of coverage will fall.

The most convincing argument for the extension of TRIA is that terrorist acts are entirely different from other events that insurers cover, and TRIA fills a permanent gap in the market that has emerged in the wake of 9/11. TRIA is therefore more like permanent deposit insurance than temporary government programs such as TAG. And just like the deposit insurance fund, any federal payment of covered terrorism-related losses can be recouped by assessments on policyholders. TRIA is fiscally responsible.

Congress perhaps should consider the appropriate way to make TRIA permanent while at the same time ensuring that insurers are not gaining at the taxpayers' expense. This would bring the U.S. in line with other developed countries that face similar threats.

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ENDNOTES

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