Insurance Information Institute

9/11 AND INSURANCE: THE FIVE YEAR ANNIVERSARY

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Introduction

The fifth anniversary of the September 11, 2001 terrorist attacks provides cause to reflect upon the human toll of these tragic events on the nation. A total of 2,976 people perished in the attacks in New York, Washington and Pennsylvania.

Of course, the tragedy of September 11 carried with it an economic dimension as well. The Milken Institute estimates that the economic costs associated with the event approach $200 billion, with economic losses in New York City exceeding $90 billion. Indeed, the events of September 11 have brought about dramatic shifts in government and industry priorities, including insurance. Among the 14 major pieces of legislation related to homeland security enacted in the aftermath of September 11 was the Terrorist Risk Insurance Act (2002).

The September 11 attacks demonstrated the vital role insurance plays in providing financial security to protect people and their property. To date, total insurance claim payments arising from September 11 are estimated at $35.9 billion as of May 2007, including property, life and liability insurance claim costs (see Figure 1). For commercial property and casualty (P/C) insurers, the damages arising from September 11 constitute what actuaries call an “extreme event.” Five years later, insurance industry leaders and public policymakers continue to consider how the underwriting of political risks—particularly international terrorism—is best handled within the insurance and reinsurance sectors.

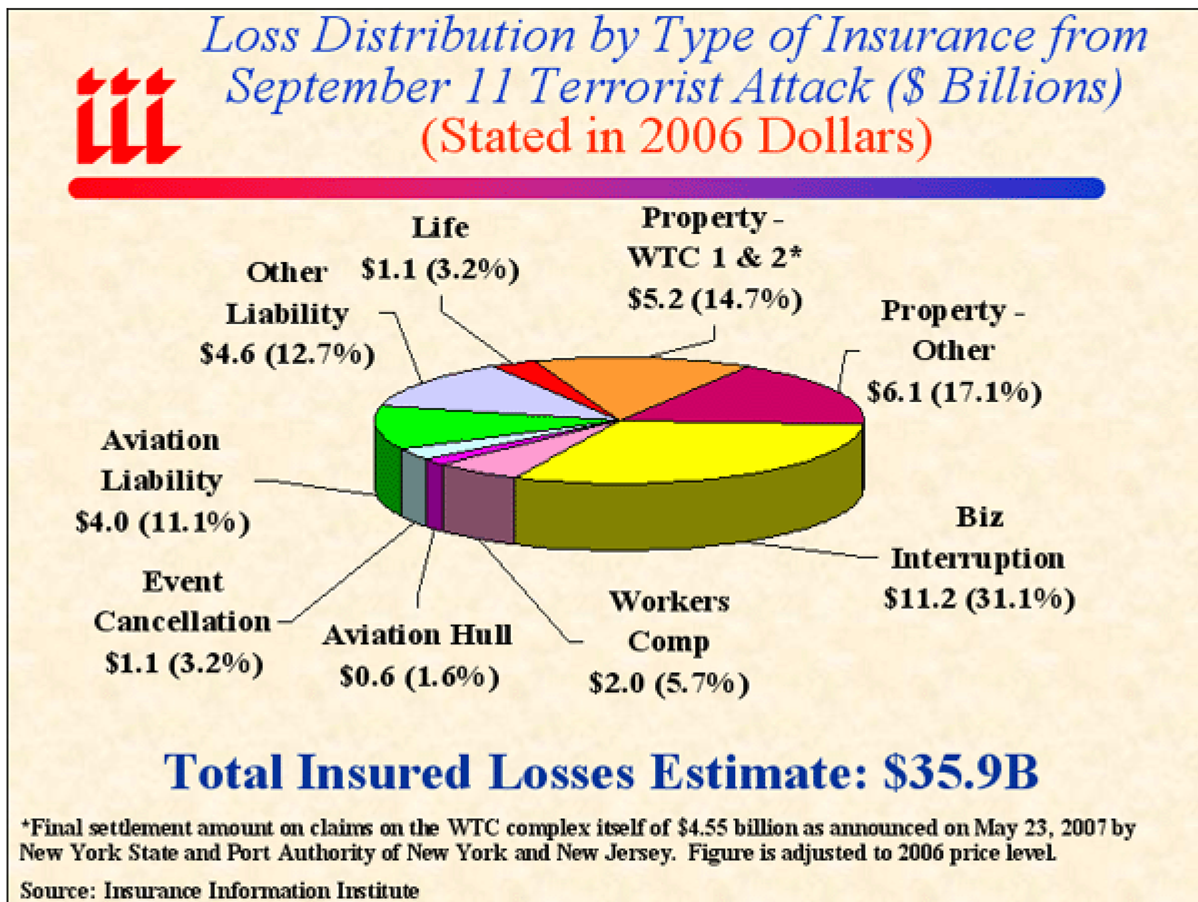


Figure 1.

Prior to September 11, few insurance policies excluded coverage for damages caused by acts of terrorism. In the wake of the attacks, insurers and reinsurers moved to exclude coverage. The few standalone policies that emerged offered only very limited coverage and were often prohibitively expensive. Coverage against terrorist acts was restored only after enactment of the Terrorism Risk Insurance Act of 2002, which was revised and extended at the end of 2005. The commercial P/C insurance industry continues to lack the capacity and resources to cope with repeated acts of large-scale terrorism, and many insurers have openly questioned whether terror risk is insurable.

Terrorism Risk Insurance

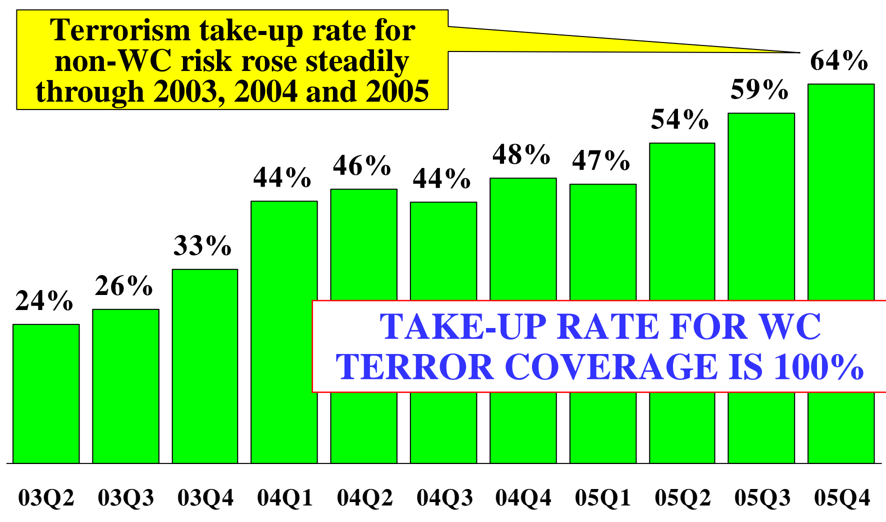
The availability of affordable terrorism insurance is deemed by many to be an important instrument for financial protection in many key sectors of the U.S. economy. The Terrorist Risk Insurance Act (TRIA) of 2002 was enacted by the U.S. Congress more than 14 months after the September 11, 2001 attacks, as concerns mounted about the economic impacts associated with inability of businesses to purchase adequate protection against terrorist attacks. The primary intent of the act was to ensure the availability and affordability of terrorist risk insurance. The act obligated P/C insurers to make terrorism insurance available, while providing federal reinsurance for losses arising from large-scale terrorist-related incidents.

Prior to September 11, insurers provided terrorism coverage to their commercial insurance customers essentially free of charge, owing largely to the perceived unlikelihood of large-scale terrorist attacks on U.S. soil. In the immediate aftermath of September 11, insurers began to reassess the risks posed by terrorism. For the remainder of 2001 and for much of 2002, terrorism coverage was scarce, and the little coverage available was very expensive. Primary insurers filed requests with their state insurance departments for permission to exclude terrorism coverage from their commercial policies. For similar reasons, reinsurers were unwilling to reinsure policies with exposure to urban areas perceived to be vulnerable to attack. Obtaining reinsurance for high-risk facilities such as power plants, chemical plants, ports and airports—no matter where they were located—became difficult.

Concerned about the limited availability of terrorism coverage in high-risk areas and its potential impact on the economy, the U.S. Congress passed TRIA on November 26, 2002. The legislation provides federal reinsurance (a “backstop”) for major terrorist-related losses.

Terrorism Insurance Market Response

A recent report from the insurance brokerage firm Marsh, Inc. indicates that take-up rates for terrorism coverage (i.e., the percentage of firms buying the insurance) have increased significantly since 2003 (see Figure 2). As of year-end 2005, nearly two-thirds of businesses had purchased terrorism risk insurance policies. Real estate firms, financial institutions, health care facilities and media companies are the most likely buyers of the coverage. Marsh also reports that the average price of terrorism insurance dropped 25 percent in 2005 as compared with the previous year.



Source: *Marketwatch: Terrorism Insurance 2006,* Marsh, Inc.; Insurance Information Institute.

Figure 2.

Role of the Federal Government

In recent testimony before a Congressional committee analyzing the long term availability and affordability of terrorism insurance, commercial insurers and reinsurers reiterated their belief that terrorism is uninsurable because the frequency and severity of the attacks cannot be reliably assessed. As insurers continue to work towards a long-term plan for terrorism risk insurance, all segments of the industry agree that the federal government must play a substantive role in any terrorism insurance system.

Foreign Terrorism Risk Insurance Programs

Many countries have, of course, been dealing with the specter of terrorism for decades, and have established their own terrorism insurance programs. Australia, Austria, France, Germany, The Netherlands and Spain have all created programs to deal with terrorism on their own shores. In 1993, the British 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. 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 amount is based on the company's share of the total market. The maximum industry retention increases annually per event and per year. Following September 11, coverage was extended to cover all risks, except war, including nuclear and biological contamination, aircraft impact and flooding, if caused by terrorist attacks. In this way, the British government acts as the reinsurer of last resort, guaranteeing payments above the industry retention.

Assessing Potential Losses

One rationale for a substantive federal role in terrorism insurance is that the losses associated with acts of terrorism are potentially quite large and could destabilize private insurance markets. A recent study by the American Academy of Actuaries explored the insured losses that chemical, nuclear, biological and radiological (CNBR) incidents might give rise to in four U.S. cities. In New York, a large CNBR event could cost as much as $778.1 billion, with insured losses for commercial property at $158.3 billion and for workers compensation at $483.7 billion. In addition to New York, three other cities were included in the analysis: Washington, D.C., San Francisco, CA and Des Moines, IA (see Figure 3). It is worth noting that in some scenarios these damage projections far exceed the $163.9 billion of the estimated $427 billion policyholder surplus for 2005 available to cover terrorism risk, after deducting the surplus of excluded lines from total surplus.

Insured Loss Estimates: Large CNBR Terrorist Attack ($B)

Type of Coverage	New York	Washington	San Francisco	Des Moines
Group Life	$82.0	$22.5	$21.5	$3.4
General Liability	14.4	2.9	3.2	0.4
Workers Comp	483.7	126.7	87.5	31.4
Residential Prop.	38.7	12.7	22.6	2.6
Commercial Prop.	158.3	31.5	35.5	4.1
Auto	1.0	0.6	0.8	0.4
TOTAL	**$778.1**	**$196.8**	**$171.2**	**$42.3**

Source: American Academy of Actuaries, Response to President's Working Group, Appendix II, April 26, 2006.

Figure 3.

The Terrorism Risk Insurance Extension Act of 2005

At the end of December 2005, the U.S. Congress approved the Terrorist Risk Insurance Extension Act (TRIEA). The legislation extends and—as outlined below—revises the 2002 Act, greatly increasing the share of losses private insurers must pay in the event of a terrorist attack while at the same time significantly narrowing the scope of coverage. The following are among the extension act's major provisions.

"Make Available" Requirement: The act retains the existing requirement that insurers make coverage available in all lines covered by the program. However, certain lines previously covered by TRIA are now excluded:

- Commercial automobile insurance
- Burglary and theft insurance
- Surety insurance
- Professional liability insurance
- Farm owner multi-peril insurance

Triggering event: The threshold for the program to go into effect has—as of March 2006—risen to $50 million in aggregate property and casualty insurance losses and must be declared a certified act of terrorism by the Secretary of the Treasury. Under the original 2002 act, the threshold was set at $5 million. In 2007, the triggering event threshold will rise to $100 million. No declaration is needed to trigger coverage under home and private passenger auto and life insurance policies because there are no

exclusions for terrorism. The extension act, like TRIA, is limited to international terrorism committed on behalf of any foreign person or foreign interest on U.S. soil (however, damage to an air carrier or vessel outside the United States, or to the premises of a U.S. mission, is also covered).

Individual Insurer Retention Level (also known as the "Insurer Deductible"): The individual insurer retention level is the amount of terrorism losses that an individual insurance company must pay before federal assistance becomes available. This level rises from 15 percent of an insurer's direct earned premiums for commercial P/C insurance over the immediately preceding calendar year to 17.5 percent in 2006 and to 20 percent in 2007.

Co-Payments: The share of losses that insurers pay above their individual retentions—10 percent and 15 percent in 2006 and 2007, respectively.

Industry Retention Level (also known as the "Insurance Marketplace Aggregate Retention Amount"): The insurance industry as a whole must cover a certain amount of losses before federal assistance is available. This amount rises from $15 billion in 2005 to $25 billion in 2006 and to $27.5 billion in 2007. The difference between this amount and the aggregate amount that insurers must pay (deductibles and co-payments) can be recouped from commercial policyholders through a surcharge not to exceed 3 percent of premium for insurance coverages that fall under the TRIEA program.

The Need for a Federal Backstop

Terrorism risk poses unprecedented challenges—conceptual, technical and operational—for commercial insurers and reinsurers. Studies by various organizations have supported the idea of a substantive federal role in terrorism insurance, including the University of Pennsylvania's Wharton School, the RAND Corporation and the Organization for Economic Co-operation and Development (OECD). The OECD notes that, thus far, the financial markets have shown little appetite for terrorism risk, largely due to the enormity and unpredictability of the exposure. RAND has argued that any long-term solution for providing terror coverage must address the risk of attacks by domestic terrorists and chemical, biological, radiological and nuclear attacks, neither of which are covered under the existing legislation.

Numerous sectors of the U.S. economy are considered by many (including the GAO and the Department of Homeland Security's own Inspector General) to be highly vulnerable to terrorist attack(s):

- Maritime and shipping
- Energy and utilities
- Food and agriculture
- Entertainment, travel and hospitality
- Financial services

Working Towards a Secure Future—The Importance of Public-Private Partnerships

National security in the post-9/11 era remains a pressing and complex challenge for the United States and its allies. The recently thwarted terrorist plot to detonate fluid-based explosives on U.S. bound transatlantic flights is a sobering reminder that transnational terrorism remains a real and dangerous threat.

For its part, the insurance industry recognizes the important role that it plays in protecting people and property from perils both man-made and natural in origin. As an instrument and enabler of loss mitigation and financial recovery, the insurance industry is an essential component of the global war on terror. Other reasons why private insurers and the federal government must continue to work in tandem include the following:

- There is a clear need for the federal government and insurance industry to continue a shared responsibility to provide terrorism coverage because a public/private partnership is the most cost-efficient way to manage terrorism risk. Moreover, the program costs the federal government and taxpayers nothing under the vast majority of circumstances.

- Terrorist actions are inextricably linked to actions of the state. Since the public sector controls virtually all of the ways and means of influencing, deterring and destroying terrorists, it is inconsistent to turn to the private sector and demand protection from the financial consequences of its own actions.

- There is nothing unprecedented in the concept of TRIA. Public/private partnerships are the preferred approach to terrorism risk management and risk transfer adopted by many countries around the globe. Numerous nations across the globe have developed federal programs to insure and/or reinsure terrorism risk.

- The ultimate beneficiaries of TRIA are the nation's six million business owners and their 150 million employees. In the absence of TRIA, many businesses in key industries would be unable to borrow, build or hire workers, resulting in a drag on the overall economy.