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TRIA Renewal: Key Questions

The federal government directly participates in insurance against terrorist attacks of up to $100 billion per year. It does this under the Terrorism Risk Insurance Act of 2002 ("TRIA"), which is up for renewal this year. TRIA was enacted in November 2002, and is in effect until December 31, 2005. This law provides a federal financial backstop for the insurance industry for claims from certain terrorist attacks, and requires that every U. S. property and casualty insurer offer terrorism insurance as an option to the businesses it insures.

This paper summarizes key policy questions facing Congress as it considers renewal of TRIA.

- Should the federal government provide terrorism reinsurance?
- Should it charge for such reinsurance?
- Should chemical, biological, radiological, and nuclear attacks be covered?
- Should domestic terrorism be covered?
- Should financial responsibility be clarified for attacks costing more than $100 B?
- Have operational questions been properly addressed?

The author draws heavily on three longer papers by Debra Roberts, available on our website, www.coffi.org. Those papers explain the complex background and operations of TRIA, as well as providing a glossary of terms and references to the academic and commercial literature on terrorism risk insurance.

As always at the Center On Federal Financial Institutions, we do not recommend a course of action, but attempt to neutrally summarize the options available to policymakers.

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Should the federal government provide terrorism reinsurance?

There is a strong consensus in the policy community that the nation benefits from the ability of businesses to insure themselves against the costs of terrorist attacks. There is no such agreement that the federal government should act as a "reinsurer."

Background

Reinsurers play an important role in the private insurance system. Insurers buy bulk protection from reinsurers against an aggregation of losses on individual insurance policies that would add to an unhealthy level for the insurer. Reinsurance is most often purchased to protect from hurricanes, earthquakes, and other catastrophes that can create very high levels of concentrated losses for an insurer. Insurers in the private sector pay an insurance premium to reinsurers in exchange for an agreement to bear most or all of the insurer's losses once they reach a specified level. Reinsurers operate on a global scale and are of sufficient size that they believe they can diversify their risks enough to live with each particular concentration of risk that they accept.

Claims resulting from terrorist attacks were implicitly covered in virtually all commercial insurance policies prior to 9/11, except that chemical, biological, and nuclear terrorist attacks could be excluded under the same theory as "war risks." To the extent that they even examined the issue, insurers were willing to provide such insurance because of the low perceived risk and the fact that reinsurers would absorb most of the costs, as they in fact did with the events of 9/11.

Having absorbed $30-40 billion of losses on 9/11 (the number is still in flux), reinsurers began to systematically exclude such risks from the coverage they provided insurers. These insurers therefore put in their own exclusions in order to protect their financial solvency, leaving businesses vulnerable.

TRIA was passed in late 2002 in order to restore businesses' ability to buy terrorism insurance. The federal government mandated that property/casualty insurers, who are normally regulated only by the states, offer terrorism insurance to their business customers. In exchange, the federal government agreed to bear much of the cost of large claims from terrorist attacks that cost up to $100 billion a year. (See the other papers on TRIA at www.coffi.org for the full, complicated, details.) The law does not clarify who would pay losses beyond $100 billion, but it seems probable that the federal government would end up absorbing most if not all of such costs, given the likely political realities after an attack of such magnitude.

Arguments for federal terrorism reinsurance

There appears to be insufficient private capacity today. Few observers believe that there is currently sufficient interest and capability for commercial insurers to provide the full level of desired terrorism coverage. Insurance industry groups have made clear that they believe the private sector is far from ready to replace the federal role. This view is bolstered by significant capacity constraints in the market for private insurance that goes beyond what is covered under TRIA.

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Terrorism risk may be uninsurable by private markets. Insurance operates on the principle that infrequent losses that would be unbearable to a single unlucky party can be shared across a large set of vulnerable parties, so that the cost to each becomes acceptable. Insurers charge premiums based on the level of risk in order to cover the total losses. However, a variety of serious problems develop if the level of risk cannot be adequately judged. Arguably, terrorist attacks are too infrequent to allow statistical analysis and too complex for adequate prediction by other means.

Terrorism may be an intrinsically governmental issue. Government actions can significantly change the risk of terrorist attack, by either shutting down or provoking terrorists. In addition, governments have access to a great deal of secret information that would help in loss prediction.

Arguments against federal terrorism reinsurance

Federal coverage makes it difficult for a private market to develop. Terrorism insurance is a complex and high-risk venture which requires the development of new models and a willingness to take on substantial risk. It is difficult to excite insurance executives about doing this when they are competing with federal coverage that is free or cheap. Insurers also face the problem of developing a sufficiently large book of business to diversify their risks and cover their fixed costs in the face of such competition.

There is a growing private market supplementing TRIA. Despite the significant capacity constraints noted above, there is a certain amount of coverage available for terrorist acts that fall outside TRIA's tests, such as a domestic terror attack.

Models may be making loss prediction easier. Various private modeling firms appear to be making progress in loss prediction, just as they have become better at predicting the probabilities of large earthquakes and hurricanes. The more predictable the losses, the greater the ability of private insurers to operate. Of course, the quality of the models will not be clear unless and until there are more terrorist attacks that produce substantial losses for U.S. businesses.

Should the government charge for terrorism reinsurance?

TRIA provides for federal reinsurance without any up-front premium charge to the insurers. Instead, insurers bear some of the economic costs in three ways. First, there is a deductible, below which insurers bear all of the cost of an attack. Second, there is a "mandatory" reimbursement mechanism for a piece of the federal share of the costs, whereby a surcharge is attached to future premiums. Third, there is a "voluntary" reimbursement mechanism if the federal government determines that its share of the losses were unreasonably large and that insurers and policyholders could bear additional premium surcharges. (Note that the terminology is confusing, it is voluntary to the federal government, but would be a compulsory charge to insurers/policyholders, if activated.) Reimbursements do not cover the government's interest costs, therefore it will always lose money on any attack that triggers federal payments.

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Arguments for charging premiums

Free coverage dilutes incentives for risk reduction. As is emphasized in CBO's study, "Federal Terrorism Reinsurance: An Update" (from January, 2005), many businesses are in a position to take actions that would reduce the probability and level of potential losses from an attack. Such actions usually cost something and may not be taken if very low cost insurance is available to cover the economic costs of an attack.

Private markets might develop without low-cost federal competition. Reinsurers might choose to re-enter this market in a substantial way if they saw a realistic chance to compete for the premiums for terrorism reinsurance that fall in categories currently covered under TRIA, which represents the bulk of the market.

Federal subsidy costs would be reduced or eliminated. There is clearly a substantial subsidy provided by the federal government, even though current budget rules do not show it. The government is promising to make future payments if large terrorist attacks occur and is being paid nothing to do so. As noted, the reimbursement mechanism would never recover full costs for the federal government. It is also arguable whether political pressures would ever allow the "voluntary" reimbursement mechanism to ever be used.

Known, up-front premiums provide more certainty for insurers. Insurers face substantial uncertainty under TRIA as to the economic effect of a terrorist attack. For example, the government theoretically can require reimbursement above and beyond the mandatory surcharges that it must levy under the law. No private reinsurer would have such a right to come back to the insurer after the fact for an unknown amount. (Admittedly, no private reinsurer would enter a contract where it could only lose money.)

Arguments against charging premiums

Setting the right price would be hard. In addition to the numerous technical difficulties in predicting the probability of losses, federal insurance programs have traditionally been subject to political pressures to keep prices low. Of course, any level of premium could achieve some of the positive effects listed above.

A substantial federal bureaucracy could develop. If prices are intended to be set in line with actual risks, there might need to be a significant federal reinsurance company to determine the right premium levels. Two alternatives both have their own disadvantages. The pricing could be contracted out, with some loss of federal control. Or, prices could be set with only a gross relationship to risk, such as with three or four bands of risk, with all risks within a band charged the same price.

Mispricing could distort behavior. If premiums are significant, but only loosely related to underlying risks, businesses might find it advantageous to take steps to move into a different risk category, even if they represent a waste of resources in the particular case.

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Perhaps the federal government *should* subsidize terrorism insurance. The federal government makes large payments through FEMA and other agencies to mitigate the losses businesses suffer from natural disasters. Some of the same logic could apply here, with the additional point that the federal government arguably has a greater responsibility (and possibly opportunity) to avoid terrorist acts than is the case with a natural disaster.

Federal exposure could potentially be higher. Premiums tend to go hand in hand with true risk absorption, so the quid pro quo for federal reinsurance premiums may be a reduction or elimination of the post-attack surcharges that are intended to partially reimburse the government. If premiums are inadequate, or the government unlucky, it could be worse off than with the ability to collect reimbursement.

Should chemical, biological, radiological, and nuclear attacks be covered?

The intent of TRIA was to roll back the wave of insurance exclusions that were put in place after 9/11. Traditional insurance exclusions that predated 9/11 were generally allowed to remain in place. The most significant of these can result in a lack of insurance coverage for some of the most frightening sources of losses: chemical, biological, radiological, and nuclear (CBRN) attacks.

Arguments for covering CBRN losses

Fundamentally these losses are similar to other terror losses. Intuitively, it seems odd to protect businesses from some types of losses caused by terrorists, but not from others. There does not appear to be a fundamentally different public policy interest at stake.

Many businesspeople may think they are already covered. Terrorist attacks are so closely linked in many people's minds with CBRN that it would be surprising if the public, and even many businesses, were aware that they were not covered. Even if the insurance buyers in a large organization are aware of this void, the higher level executives may not be.

It may be hard to distinguish from conventional attacks. Complex rules and political judgments may be required to decide how to handle a mixed attack. For example, how much should TRIA cover if there is some element of CBRN attack, but the bulk of the damage comes from conventional explosives? Several years of litigation ensued after 9/11 to determine whether it was one attack or two (one for each plane.) It is easy to imagine similarly complex judgments being called for here.

It may be particularly difficult to mitigate CBRN losses. It is difficult to generalize, but it seems likely to be more difficult for a business to avoid or reduce the effects of CBRN attacks than to do so from a conventional bomb or other attack.

These attacks are the most frightening. To the extent that insurance is partially intended to provide peace of mind and therefore to encourage businesses to take risks, there is a stronger argument for CBRN coverage than for some kinds of coverage the government already provides.

Arguments against covering CBRN losses

Insurers might have to charge businesses more. Insurers would be on the hook for a portion of losses that do not affect them today, because of their exclusions. Under TRIA, there are deductibles and some repayments to the federal government, even if the bulk of the losses are transferred to the government. Businesses are not currently charged for transferring the risk of CBRN attacks, since insurers refuse to take those risks. Voiding these exclusions should logically lead to some increase in premiums.

Potential federal losses would be higher. This would be a significant expansion of TRIA's coverage, since many experts believe CBRN attacks are likely and could be extremely costly. On the other hand, there is a strong likelihood that the federal government would choose to absorb at least some of these losses even without formal coverage under TRIA. It would arguably be good public policy and there would certainly be strong political pressure to do so.

Should domestic terrorism be covered?

Terrorist acts that have a purely domestic origin are not covered by TRIA.

Arguments for including domestic acts

Fundamentally these losses are similar to other terror losses. As with CBRN, it is likely that a majority of the public assumes terrorism cover would include domestic losses. It is difficult to formulate a compelling reason for this differentiation.

It may be hard to tell when an attack is domestic. A major act of terrorism by a domestic group is likely to be followed by claims of responsibility by foreign groups. There may also be cooperation of at least a minimal nature. For that matter, there might be one foreign member of an essentially domestic group. It could be years, if ever, before such questions are fully resolved.

Arguments against including domestic acts

Perhaps TRIA was intended to solidify the U.S. against foreign terrorism. As noted, it is difficult to discern a policy rationale for exclusion of domestic terrorism. Most arguments were economic and would apply equally to attack by a domestic group. However, perhaps there was some feeling that good insurance coverage would make it easier to stand up to terrorists who were attempting to influence our foreign policy. Even here, it is difficult to see why we would be less interested if terrorists were trying to influence our domestic policy.

Should financial responsibility be clarified for attacks costing more than $100 billion?

TRIA does not indicate who would bear the bill for attacks in a given year totaling more than $100 billion.

Arguments for clarification

It may be better to have a plan. Times of severe crisis are usually not the best times to formulate a plan to deal with a complex situation.

Deferring a decision may be tantamount to providing free coverage. Given the public's normal reaction to other disaster situations, the government is highly likely to pick up the bill, unless some other mechanism is in place.

Arguments against clarification

Unique situations may require unique solutions. An attack of this unprecedented magnitude may raise issues different from what we presume today.

Have operational questions been properly addressed?

Fortunately, the Terrorism Risk Insurance Program (TRIP), established by TRIA, has never been tested, since no substantial terrorist attack covered by TRIA has occurred. Now, while Congress is considering renewal of TRIA, would be an opportune time to make sure that all significant operational questions have been worked out. Some questions to consider are:

Do we know how to deal with an attack that may be domestic or may be foreign? As noted earlier, uncertainty could produce major complications.

Do we know how to deal with an attack that may have used CBRN? What do we do if CBRN was only a minor part of the destruction? Again, these points were discussed above.

Do policyholders and insurers truly understand how TRIA works? There is reason to doubt this. For example, considerable public discussion, even in Congress, has implied that CBRN attacks are definitely always covered. For another example, we found that the website of a major insurance broker contained a numerical example of how costs would be split between insurers and the government that was wrong, because it assumed the mechanism was different than it actually is.

Are FEMA, law enforcement, state insurance regulators, and other parties adequately prepared to coordinate with TRIP? A terrorist attack is likely to produce massive confusion for considerable time. It would be useful to have taken all reasonable steps to prepare in advance.

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