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The Center On Federal Financial Institutions (COFFI) is a nonprofit, nonpartisan, non-ideological policy institute focused on federal insurance and lending activities.

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Terrorism Risk Insurance Policy Forum

The federal government takes on much of the financial risk for terrorist attacks of up to $100 billion per year, under the terms of the Terrorism Risk Insurance Act of 2002 ("TRIA"). TRIA was enacted in November 2002 and will expire on December 31, 2005, unless reauthorized. (See www.coffi.org for a primer and other papers on TRIA.)

COFFI held a Policy Forum on May 2, 2005 to present a range of views among affected parties and experts as to whether TRIA should be renewed and, if so, whether it could be improved. A transcript of the event is available at www.coffi.org. Here we present a summary of the key points.

Debra Roberts, a Fellow of COFFI, acted as a neutral moderator and provided a short introduction to TRIA for those less familiar with the topic. The panelists represented a diverse range of viewpoints and included representatives of: the insurance industry; the real estate industry – key buyers of terrorism insurance; a consumer group; a financial economist; and the head of the Congressional Budget Office. Specifically, the panelists were:

- James W. Macdonald of ACE Insurance
- J. Robert Hunter of the Consumer Federation of America
- Jeffrey D. Deboer of the Real Estate Roundtable
- Kent Smetters from the Wharton School
- J. Stephen Zielezienski of the American Insurance Association
- Douglas Holtz-Eakin of the Congressional Budget Office

Our summary is broken down into two over-arching questions: should TRIA be renewed at all and, if so, should it be altered? The author is solely responsible for the summarization, which has not been signed off on by any participant.

Should TRIA be renewed?

The threshold question is whether it is appropriate to have a federal role in terrorism risk insurance. Panelists expressed sharply differing views on that basic query. The representatives of the insurance and real estate industries firmly stated their belief that it was essential, while others were more skeptical. Six principal questions were discussed:

Has TRIA worked? There was broad agreement among the panelists that TRIA provided the insurance availability that Congress intended. As Mr. Macdonald put it, “TRIA has achieved most of its goals … [i]t has made terrorism insurance broadly available and affordable for businesses that want and need this vital coverage.” Mr. DeBoer indicated that this may have translated into 300,000 jobs by breaking a logjam of $15 billion of real estate projects. Dr. Holtz-Eakin noted, that, “for a bandaid, TRIA was relatively successful.”

However, as discussed below, there was fierce disagreement as to whether TRIA had succeeded in its other goal of giving the private sector time to create adequate mechanisms to take over from the federal government, so that the temporary program established under TRIA could be ended.

Is terrorism risk insurable by the private sector, given the difficulty in estimating the frequency and severity of attacks? Mr. Macdonald stated that “the pricing of terrorism insurance is based not on sound actuarial data, because none is available.” Mr. Zielezienski flatly noted, “[t]errorism is not insurable,” and went on to emphasize the difficulty of estimating future losses from attacks by a determined and adaptable human enemy, as opposed to natural catastrophes that follow physical principles.

Mr. Hunter rejected the argument that estimation difficulties render terrorism risk uninsurable. In particular, he cited the success of federal insurance against riot losses, a now-defunct program he ran at one time. These risks were also infrequent, large, and subject to the vagaries of human behavior. He stated that the program was actually modestly profitable for the federal government and, he implied, provided important protection to buyers. Messrs. Zielezienski and DeBoer explicitly rejected the comparison with riot insurance, in part based on a major difference in scale of risk.

Dr. Smetters touched on various areas of the private financial markets where he felt that risks that were difficult to price still found takers. In his words, “[t]here’s a difference between a tough job and a market failure.” In his view, the private market should theoretically be able to provide terrorism coverage.

Are the risks too big for private insurers? Mr. Macdonald indicated that a loss could “range well above $200 billion.” Mr. Zielezienski stated that the loss could be $250 billion. Both figures exceed the $175 billion in total capital that supports commercial lines insurance. Mr. Macdonald emphasized on several occasions that *individual* insurers write the policies and their exposure must be kept in proportion to their *individual* capital, since it is unlikely that a loss will be spread evenly across the industry.

Dr. Smetters rejected the relevance of the size argument. As he put it, “[c]ompanies are different than you and I as people … [they] are owned by well-diversified shareholders.” These shareholders, in the aggregate, can easily shoulder losses on their shares that substantially exceed the size of terrorism losses. For example, the attack on 9/11 created insured losses equal to approximately a 0.3% move in the S&P 500.

Mr. Hunter accepted the size argument as potentially valid, but felt insurers should absorb at least the first $50 billion of after-tax loss, (roughly $75 billion before taxes.) This would be almost four times his estimate of $13-14 billion in after-tax cost to insurers, after federal reinsurance, had TRIA been in effect with current limits on 9/11.

Do national security factors make it a public endeavor? In Mr. Zielezienski's words, "[w]e have declared war on terrorism and we don't fight war in the private sector. We fight war as a matter of national policy. Certainly, insurers can be a part of that; but certainly, the government has to be a part of that, too." Messrs. Macdonald and DeBoer both indicated that minimizing the impact of a terrorist attack on our economy was a national security issue, since it would help allow us to stand up to such attacks.

Dr. Smetters dismissed some of the industry assertions as "cheap patriotism arguments … that don't hold water," although he did not indicate which of the arguments he disagreed with fell into that category.

Dr. Holtz-Eakin stated that "[w]e should rethink how we configure our economy for a war on terrorism." However, he implied that such a reconfiguration could involve a lesser governmental role than TRIA created.

Does a private market exist today that is fully capable of providing terrorism coverage? Mr. Deboer quoted a report from Moody's, the rating agency, that said "Moody's is unaware of any viable private market initiative that would take the place of TRIA." He also alluded to Chairman Greenspan's statement that there is no evidence that a private terrorism market has yet developed.

Mr. Hunter and Dr. Smetters both countered with the argument that there IS a private terrorism insurance market today. Dr. Smetters specifically said that "[s]eventy percent of the companies buying TRIA-type policies are also buying additional policies on domestic acts of terrorism that won't be covered by TRIA." He also argued that private terrorism insurance was available during the year between 9/11 and the passing of TRIA and that "prices were coming down over time."

Dr. Smetters did concede that imperfections in the regulatory structure of the insurance industry made it impossible to achieve completely effective private terrorism insurance today. However, he quoted Milton Friedman, "bad policy begets bad policy," to argue for removing the bad regulations rather than continuing with a federal program to offset the bad regulation.

Could a private market develop while TRIA exists? Mr. Hunter and Dr. Smetters contended that TRIA's very existence makes it difficult for private market solutions to develop, on the basis that free reinsurance is hard to compete against. Mr. Zielezienski disagreed, citing the significant levels of risk falling on private insurers under TRIA, which he felt left sufficient incentive for innovation, within the overall limitation that he does not believe terrorism risk is insurable without federal help.

Potential Improvements to TRIA

Many advocates of TRIA promote a temporary renewal of the law with little modification from its existing form, arguing that the program works and that more time is needed to design a more comprehensive set of improvements. Mr. Macdonald strongly endorsed the Dodd-Bennett bill that proposes an extension of two years, saying “I particularly like that bill because it has within it a plan to try to develop a permanent solution to this challenge.” Mr. Deboer added, “TRIA has been a tremendous success and it, or something much like it, should be continued.”

Other panel members suggested a number of significant potential changes, including:

Charging insurers premiums to cover the expected value of future government payments under TRIA. Surprisingly, there was a consensus on the panel that it would be fair and appropriate to charge insurers for the federal government’s reinsurance protection. Dr. Holtz-Eakin devoted considerable time to emphasizing the important mechanism that pricing plays in encouraging appropriate behavior. He noted that “to adjust our economy to sustain terrorism risks, putting in place policies which are explicitly designed to insulate people from those risks is unlikely to be successful.” Instead, pricing information conveyed through financial markets and insurance premiums “can direct mitigation wherever it’s possible to do so … to shift the burden of the costs of terrorism in a voluntary and, hopefully, efficient fashion.”

Mr. Hunter viewed the lack of a charge for the federal reinsurance as a “hand-out” that the insurers do not need. He estimated this subsidy as worth roughly a billion dollars a year. Dr. Smetters asserted that “every economist agrees with pricing TRIA.”

The other panelists, representing parties that would bear the cost of a federal reinsurance premium, did not suggest such a charge. However, when asked directly, Mr. Macdonald answered, “[i]t’s hard to debate the argument that some charge should be made. It’s impossible to.” Mr. Zielezienski added the caveat that there shouldn’t be actuarially fair pricing of the reinsurance if insurers were not allowed to charge actuarially fair prices to their customers. Mr. DeBoer did not explicitly endorse premiums, but said “we’ve never argued this on a price point of view. It is an availability issue.”

Raising the level of deductibles paid by insurers before the federal government pays anything. This suggestion follows the earlier lines of argument that private markets could cover all terrorism risks, or at least a much higher amount than required under TRIA currently. Dr. Smetters suggested, “[i]f we’re going to have a TRIA extension, let’s just keep in tune with the philosophy of TRIA. That was to be a receding role for the Government. So let’s increment the retention levels.” As noted earlier, Mr. Hunter thought a $50 billion, after-tax, deductible might be appropriate.

Mr. Macdonald, on the other hand, focused on the importance of keeping deductibles low enough to assure the solvency of insurers. He pointed out that “[t]he 15 percent retention today … translates in some cases to 20, 30, 40, more than 50%” of capital. At that level, if “you sustain a large loss … you will likely be out of business long before you get to the federal reinsurance level.”

Broadening TRIA’s coverage to include domestic terrorism. Several panelists urged including domestic terrorism and none spoke against it. Mr. DeBoer said “absolutely, it ought to be covered." He and Mr. Macdonald both noted the great difficulty in ascertaining whether an attack was domestic, foreign, or foreign-inspired but domestic.

Broadening TRIA's coverage to include Group Life insurance. Both Mr. Hunter and Dr. Smetters strongly opposed expanding TRIA to cover losses on Group Life insurance. An audience member representing the American Council of Life Insurers took issue with this stand. Mr. Zielezienski. responded "Did you say that group life can't exclude terrorism? Because that would be similar to workers' compensation, I think. There's no reason why it shouldn't be included."

Ensuring that businesses were covered against losses from chemical, biological, nuclear, and radiological attack. Most of the panelists explicitly or implicitly talked about the importance of protecting against the financial risks from CBNR attacks. However, there was a significant divide on the question of the extent to which TRIA was covering such risks. There was no dispute that TRIA will provide coverage if the underlying insurance policy does so – the argument was whether these policies effectively do so.

Mr. DeBoer flatly stated the view that appears most widespread in the industry, that while "TRIA does cover these events, if in fact a primary insurer will write the coverage. We see no evidence in America today that it's being written." (It seems clear from context that Mr. DeBoer was not disputing that workers' compensation insurance automatically covers all kinds of terrorist attack, along with any other cause of loss.) Mr. Macdonald countered later that "some confusion is arising over those exclusions which exclude NBCR for non-certified, so-called 'other acts of terrorism.' There are exclusions in the market that apply an NBCR exclusion to other acts of terrorism, but not to TRIA. I know of no policy we underwrite that excludes NBCR for TRIA."

Limiting TRIA to focus on insurance for workers' compensation and high risk locations. Dr. Holtz-Eakin suggested that one of several potential strategies would be to "focus the next version of TRIA more closely on those things which jump out as difficulties in the current environment … [m]aybe a federal program could focus on workers' compensation as well as the risks faced by landmark properties." No other panelists commented on this suggestion.

Conclusion

This summary necessarily omits a great number of sub-topics, as well as some excellent explanations of the positions of the various panelists. Readers who are interested would be well-advised to read through the 34-page transcript, available at www.coffi.org