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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 Act of 2002: A Primer

The federal government directly participates in the insurance against terrorist attacks of up to $100 billion per year. It does this under the Terrorism Risk Insurance Act of 2002 ("TRIA"), which 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 insurance company offer terrorism insurance to its commercial policyholders.

TRIA is currently under review by the U.S. Treasury Department, and new legislation is being proposed in both the House and the Senate to extend TRIA (three bills so far). This primer explains in non-technical terms how TRIA works. It is the first in a series of three papers being published concurrently by COFFI. The other two are "Terrorism Risk Insurance: Conceptual Issues" and "TRIA: Where Do We Go from Here?". These two papers discuss the issues within a framework of economic and government policy theories surrounding worldwide terrorism today. Please note that COFFI is not advocating any particular policy options in these papers.

I would like to acknowledge the kind assistance of Jeffrey Brown, Doug Elliott, Ellen Seidman and Barbara Stewart. Any mistakes or omissions are, of course, my own.

These papers are dedicated to the memory of Vita M. Marino, who died on September 11, 2001 at Two World Trade Center, New York City.

Please refer to the glossary for an explanation of terms specific to this field.

Executive Summary

TRIA set up a risk-sharing partnership between the federal government and the insurance industry. Insurers are required to offer terrorism coverage for voluntary purchase by businesses. In turn, the federal government agrees to initially absorb a portion of the cost of large attacks. It may recoup its outlays, within certain limits, through surcharges on future insurance premiums, over a period of years.

Prior to 9/11, policies for standard commercial insurance (insurance for businesses) included terrorism coverage as part of the package, effectively free of charge. Immediately after 9/11, insurers began excluding terrorism risk from their policies, primarily as a result of the withdrawal of terrorism risk coverage by the reinsurance market. "Reinsurance" is the insurance purchased by insurance companies on certain policies they have issued. Reinsurance is a means of spreading risk for insurers to avoid concentration of certain risks in their portfolios. Insurance companies normally purchase reinsurance in order to mitigate their losses, to stabilize their earnings and to have more predictable cash flows. Many insurers will not offer the riskiest lines of insurance without such a backstop.

Without reinsurance coverage, insurers were not willing to bear terrorism risk on their own, and responded by excluding it from their policies. This situation created problems for businesses that either wanted or needed terrorism coverage for various reasons. TRIA was enacted in November 2002, and required all U.S. commercial insurance companies to offer terrorism coverage for businesses, restoring the availability of this type of coverage, and providing government funding for a portion of future terrorism losses. TRIA is designed to cover all commercial lines of property-casualty insurance for which terrorism risk applies, and includes property insurance, business interruption insurance, commercial liability insurance, workers compensation insurance and surety bonds. In a significant omission, damage from nuclear, biological and chemical ("NBC") attacks are not covered. Insurers are required only to offer terrorism coverage that is not materially different from non-terrorism coverage, and NBC accidents are typically excluded from non-terrorism coverage as well

While all insurers are required to offer terrorism insurance under TRIA, there is no requirement for businesses to purchase this coverage. TRIA sets no pricing requirements or restrictions for this coverage. There is no up-front charge by the government for its share of claims funding under TRIA. However, there are provisions, if certain conditions are met, that would require the government to be reimbursed for a portion of its claim payments by imposing an annual surcharge (not to exceed 3% of premium) on all property and casualty policyholders for a number of years. This surcharge applies whether or not a policyholder purchases coverage under TRIA.

TRIA includes a definition for "certified" acts of terrorism that are covered under its program. TRIA covers acts of terrorism committed by foreign persons against interests in the U.S. or against certain U.S. interests overseas. If the Secretary of the Treasury, in agreement with the Secretary of State and the Attorney General, denies certification of an act of terrorism, this decision is final and not subject to judicial review.

In the event of a terrorist attack covered under TRIA, the insurance industry pays a "deductible" amount first, then the federal government and the insurance industry each pay their share of the remaining amount. The federal government's share is 90% of the amount that exceeds the deductible, and the insurers' share is 10% of that amount. The deductible amount is calculated as a percentage of the prior year's relevant insurance premiums, (totalling approximately $200 billion in 2003), and increases each year that TRIA is in effect. The deductible percentages are 7% for 2003, 10% for 2004 and 15% for 2005. The amount of losses covered under TRIA is $100 billion annually. Congress determines what happens if losses exceed that amount.

TRIA expires at the end of 2005. The “make available” provisions, requiring insurers to offer terrorism insurance, were in originally in effect through 2004, with the option to be extended through 2005. In June 2004, the Treasury Department chose to extend the requirement through the end of 2005.

TRIA’s “hard” expiration date at December 31, 2005 presents some administrative problems for insurers. At the primary insurance policy level, if an insurer writes a policy in February 2005 that provides TRIA coverage and has a loss in January 2006, the federal government will not provide compensation, even though the “make available” provisions of TRIA are in effect now for policies issued in 2005. In addition, the underwriting process for commercial coverages begins several months prior to the actual renewal date of the policies, so the uncertainty about the status of TRIA beyond December 2005 will impact the primary insurance industry much earlier, even as soon as the fourth quarter of 2004.

The uncertainty in the insurance marketplace over whether TRIA will be extended or not creates problems for both insurers and policyholders as 2005 approaches and policies issued after January 1, 2005 run the risk of not having TRIA available for the full 12 months the policy is in force.

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What is TRIA?

TRIA is the Terrorism Risk Insurance Act of 2002, which was signed into law by President Bush on November 26, 2002, more than 14 months after the terrorist attacks of September 11, 2001 that precipitated its creation. TRIA is a public/private risk-sharing partnership between the federal government and the insurance industry. The program was designed to ensure that terrorism insurance would be available for businesses to purchase, and that the insurance companies would have adequate resources to cover claims from a terrorist attack.

What does TRIA do?

TRIA established the Terrorism Insurance Program within the Department of the Treasury. The program provides a federal backstop for U.S. insurance companies for a certain portion of claims, or "losses," from terrorism events, as defined by TRIA. All commercial property-casualty insurance companies operating in the U.S. are required to participate in this program. TRIA requires that these insurers "make available property and casualty insurance coverage for insured [terrorism] losses that does not differ materially from the terms, amounts, and other coverage limitations applicable to losses arising from events other than terrorism".[1]

In other words, all property-casualty insurance companies operating in the U.S. are required, under TRIA, to offer insurance coverage for terrorism risk, and the federal government, under TRIA, will cover a portion of any losses resulting from "certified" terrorism events on behalf of the insurance companies. It is a risk-sharing partnership, whereby the insurance industry covers a "deductible" amount first, then the federal government and the insurance companies each pay their share of any remaining amount. There are provisions in TRIA for both mandatory and discretionary "recoupment," or repayment, for the federal government's share of losses paid by way of a premium surcharge after an attack from all property and casualty insurance policyholders over a period of time. All of these various terms and provisions are defined in more detail in the text below.

TRIA was designed to function as a temporary replacement for the private terrorism reinsurance market, which disappeared after the terrorist attacks on September 11, 2001. "Reinsurance" is the insurance purchased by insurance companies on certain policies they have issued. Reinsurance is a means of spreading risk for insurers to avoid concentration of certain risks in their portfolios. Insurance companies normally purchase reinsurance in order to mitigate their losses, to stabilize their earnings and to have more predictable cash flows. Most insurers buy reinsurance. For example, of the total insured losses from 9/11, approximately 60% will be recovered from reinsurers.

In a reinsurance contract, the reinsurer charges a premium to the insurer to cover all or part of a loss it may sustain under its policies. Reinsurance may cover a specific risk or a broad class of business. Reinsurance is a global business. Its international nature reflects a further spreading of risk and access to broader capital markets to help cover losses. According to the Reinsurance Association of America (RAA), about 40% of all U.S. reinsurance premiums, and two-thirds of all property catastrophe reinsurance premiums, are written by foreign reinsurers.[2]

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[1] TRIA legislation, Sec. 103 (c)(1), http://www.treas.gov/offices/domestic-finance/financial-institution/terrorism-insurance/pdf/hr3210.pdf
[2] Reinsurance Association of America, http://community.reinsurance.org/ScriptContent/index_about.cfm

How did TRIA develop?

In the months following the terrorist attacks on September 11, 2001, members of the property-casualty insurance industry and other sectors began calling for the federal government to assume a role in providing financial protection against future terrorism losses. The total insured losses from 9/11 are now estimated to be between $30 and $40 billion, which the insurance industry has agreed to pay without invoking any "war risk" exclusions. "Exclusion clauses" in insurance or reinsurance contracts spell out certain types of events or circumstances for which claims will not be paid. However, in the wake of 9/11, the private market for terrorism insurance and reinsurance radically diminished. Beginning in January 2002, reinsurers (many of which are based outside the U.S.) added terrorism exclusion clauses in their contracts. Without any reinsurance available, U.S. primary insurance carriers did not want to assume the increased level of terrorism risk, and began seeking regulatory approval to exclude terrorism risk in their policies. State insurance regulators rapidly approved these exclusions, and by early 2002, 45 states had approved the use of terrorism exclusions. As a result of these exclusions going into effect, the real estate construction market was impacted. Many lenders were unwilling to provide financing for projects without adequate insurance protection for terrorist attacks. In February 2002, the GAO gave Congress testimony providing "examples of large projects canceling or experiencing delays" with the lack of terrorism coverage being cited as the principal contributing factor.[3] By October 2002, President Bush claimed that over $15.5 billion worth of construction projects were "not going forward because they can't get insurance on their projects, can't insure the building or the project."[4]

From late September 2001 through late November 2002, the insurance industry, the Bush Administration and Congress seemed to be united on the concept of the federal government providing a backstop to insurance companies to enable them to offer terrorism coverage, but differed sharply on the structure this backstop should take. The lack of agreement delayed any progress in Congress through the end of 2001, at which time the reinsurance market reacted with its terrorism exclusions beginning in January 2002. As the crisis quickly spread through the insurance industry and impacted the construction industry, the economic effects became more apparent. Finally, after the mid-term elections in November 2002, agreement between the House and the Senate resulted in President Bush signing TRIA into law on November 26, 2002.

What does TRIA cover (and not)?

For the Federal government to provide payment under TRIA, the Secretary of the Treasury must "certify" that a loss was due to an act of terrorism, defined as:

> a violent act or an act that is dangerous to—
>
> - human life;
> - property; or
> - infrastructure;
>
> to have resulted in damage within the United States, or outside the United States in the case of an air carrier or vessel, as described within the Act, or on the premises of a U.S. mission; and

[3] GAO-02-472T, "Terrorism Insurance: Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities" p. 9
[4] President George W. Bush, "Remarks on signing the Terrorism Risk Insurance Act of 2002", Weekly compilation of Presidential Documents, Proquest Information and Learning, December 2, 2002

> to have been committed by an individual or individuals acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the U.S. government by coercion.[5]

If the Secretary of the Treasury, in agreement with the Secretary of State and the Attorney General, denies certification of an act of terrorism, this decision is final and not subject to judicial review.

Prior to 9/11, standard commercial insurance policies (insurance for businesses) included terrorism coverage as part of the package, effectively free of charge. After 9/11, as discussed above, insurers began excluding terrorism risk until TRIA was enacted and required all U.S. commercial insurance companies to offer terrorism coverage for businesses. TRIA is designed to cover all commercial lines of property-casualty insurance for which terrorism risk applies, and includes:

Property coverage—includes structural coverage for commercial property such as office buildings, factories, shopping malls and apartment buildings. In some states, there is a regulation known as “fire following,” which means that in the event of a terrorist attack followed by fire, insurers would be liable to pay out losses attributable to the fire, even if a commercial policyholder had not purchased terrorism coverage.[6]

Business interruption coverage—covers financial losses that occur when a firm is forced to suspend business operations either due to direct damage to its premises or because civil authorities limit access to an area after the attack and those actions prevent entry to the business premises. Business interruption losses associated with acts of civil authority (e.g., closure of certain areas around the disaster) can only be triggered when there is physical loss or damage to the insured premises by a covered peril (e.g., fire, explosion, smoke, etc.).[7]

Commercial liability—covers all liability exposures of a business that are not specifically excluded. Exposures could include liability arising from accidents resulting from the insured’s premises or operations, products sold by the insured, operations completed by the insured, and contractual liability.[8]

Workers compensation—a compulsory line of insurance for all businesses, covers employees injured or killed on the job and automatically includes coverage for acts of terrorism because there are no exclusions allowed in workers compensation policiesin any state. Workers compensation is the only line of insurance that does not exclude coverage for acts of war. This also means that workers compensation would cover any losses from nuclear, biological, chemical or radiological events. Unlike the other lines covered under TRIA, terrorism coverage for workers compensation insurance cannot be separated out and declined by the policyholders. There are essentially three types of workers compensation benefits. The first reimburses workers for lost wages while they recover from their injuries. The second covers

[5] TRIA legislation, Sec. 102 (1)(A)
[6] Some insurers are now seeking to limit “fire following” coverage resulting from a terrorist attack because commercial policyholders that choose to reject TRIA or other terrorism coverage are effectively paying no premium for the protection offered by fire-following coverage. So far, seven states have amended their standard fire policy laws to exclude acts of terrorism. Source: Insurance Information Institute, “Terrorism and Insurance,” July 2004, http://www.iii.org/media/hottopics/insurance/sept11/tria/
[7] Insurance Information Institute, “Terrorism and Insurance,” July 2004
[8] Insurance Information Institute, Glossary of Insurance Terms, http://www.iii.org/static/site/tools/glossary_frset.htm

workers for all medical expenses incurred as a result of the injuries they sustain. The third type of benefit provides payments to the families of workers killed on the job.[9]

Surety bonds—are contracts issued by an insurance company, or surety, guaranteeing the performance of a specific obligation. Contractors are often required to purchase surety bonds for completion of their projects. The surety company becomes responsible for carrying out the work or paying the loss up to the bond “penalty” if the contractor fails to perform.[10]

TRIA excludes acts of war (with the exception of workers compensation coverage, as discussed above). Long-standing war risk exclusions in the insurance industry reflect the concept that damage from acts of war is fundamentally uninsurable. No formal declaration by Congress is required for the war risk exclusions to apply. In addition, the wording of TRIA implicitly omits coverage of nuclear, biological, chemical and radiological (NBCR) events, as these are generally not covered by commercial property-casualty policies. This is a significant omission, as it is certainly within the realm of possibility that the next catastrophic terrorism event could be caused by nuclear, biological, chemical or radiological agents. Many people might be unpleasantly surprised that TRIA provides no assistance at all in these events.TRIA’s wording also implicitly excludes acts of domestic terrorism, such as the bombing of the Oklahoma City Federal Building in 1995.

TRIA’s wording implicitly omits all personal lines of property-casualty insurance coverage, which includes homeowners and automobile insurance. Unlike commercial property insurance, standard homeowners policies include coverage for damage to property and personal possessions resulting from acts of terrorism, even though terrorism is not specifically referenced. The policy does cover homeowners for damage due to explosion, fire and smoke, which are the likely causes of damage in a terrorist attack. Auto insurance policies will cover a car that is damaged or destroyed in a terrorist attack if the policyholder has purchased “comprehensive” coverage. Therefore, personal lines policies generally include coverage for damage from terrorism.[11]

In various reports offering guidance on regulations, the Treasury Department has indicated that TRIA applies to “captive” insurers (those insurance companies set up by large corporations to handle their own business insurance needs) that meet the criteria of a qualified insurer. Any insurance entity that is licensed by a state, and receives and reports direct earned premium, is considered an insurer under TRIA and is therefore required to participate in the program. This means that if a captive insurer is licensed in the U.S., it is required to offer terrorism coverage under TRIA and is able to access the reinsurance provided under TRIA for such risks.[12]

TRIA explicitly does not cover:

certain federally backed insurance programs (such as the federal crop insurance program and flood insurance);

private mortgage insurance or title insurance;

[9] Insurance Information Institute, “Terrorism and Insurance,” July 2004
[10] Insurance Information Institute, Glossary of Insurance Terms

[11] Insurance Information Institute, “Terrorism and Insurance,” July 2004
[12] Marsh Inc. research report “Marketwatch: Property Terrorism Insurance 2004”, printed April 2004 (New York)

financial guaranty insurance issued by monoline financial guaranty insurance companies;

medical malpractice insurance;

reinsurance or retrocessional reinsurance;

health or life insurance, including group life insurance.[13]

TRIA included a provision for a study of the group life insurance and reinsurance markets by the Secretary of the Treasury, with a report to Congress within 9 months after the date of its enactment, to determine whether or not group life coverage should be added to TRIA. On August 15, 2003 the Treasury Department announced its decision not to include group life policies under the Terrorism Risk Insurance Program.[14]

How is TRIA structured?

For a certified terrorism event, TRIA provides that the federal government's share in an insured loss is 90% of the amount in excess of the insurance companies' deductible. However, unlike the standard "deductible" on a personal insurance policy, which is usually a fixed dollar amount, (say, $500.00) or the deductible, or "retention" on many reinsurance policies that is calculated as a percentage of the loss amount (say, 10% of the loss), the deductible for TRIA losses is calculated as a percentage of the insurers' premium in the relevant property-casualty lines of business in the previous year. This premium is defined in TRIA as "direct earned premium"[15], and the percentages are set per year as follows:

For 2003, 7% of 2002 premiums;

For 2004, 10% of 2003 premiums;

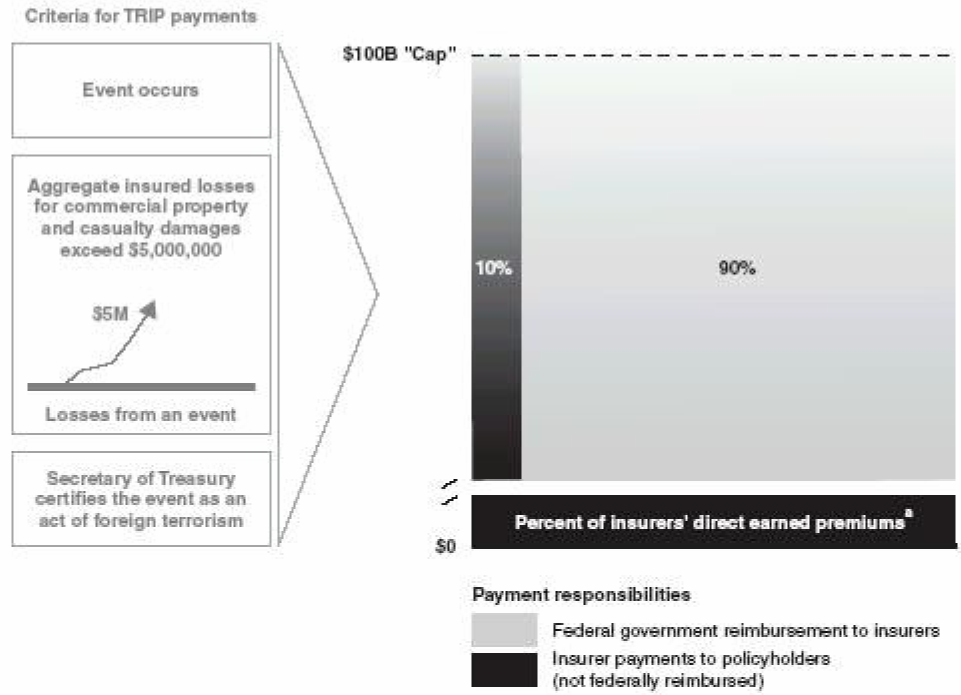
For 2005, 15% of 2004 premiums.

The increasing percentages obviously place more responsibility on the insurers each year. In addition, if the premium amounts are increasing as well, meaning that either more companies are buying coverage or that premium rates are increasing, or some combination of the two, then the actual dollar deductible for the insurers will rise even higher.

The following chart illustrates the payment obligations of the insurance companies and the federal government. The insurers' deductible must be paid first, then once that amount is exceeded, the federal government pays 90% of the amount that exceeds the deductible, with the insurers paying the other 10% of that amount.

[13] TRIA legislation Sec. 102 (12)(B)
[14] Press release dated August 15, 2003 from the Treasury Department, http://www.treas.gov/press/releases/js666.htm
[15] TRIA legislation, Sec. 102 (4)

Figure 1: Prerequisites and Limits of Coverage under TRIA



Source: GAO analysis of Terrorism Risk Insurance Act of 2002.

[a]The percentage of direct earned premiums increases each year: 7 percent in 2003, 10 percent in 2004, and 15 percent in 2005.

To illustrate how TRIA would work to cover a certified terrorism loss, here is a simplified example at the industry-wide level. Let's say there was a $30 billion insured loss during 2004 (roughly another 9/11-size loss). The insurers' deductible would be 10% of the prior year's direct earned premium, which was approximately $198.4 billion, according to data from the National Association of Insurance Commissioners, cited in an article by R. Glenn Hubbard and Bruce Deal.[16] For ease in calculation, let's round the direct earned premium up to $200 billion. The insurers' deductible would equal $20 billion. The federal government's share of the loss would equal 90% of the excess over the deductible, or $9 billion. Therefore the insurers would pay a total of $21 billion of the loss, and the federal government would pay $9 billion.

It is worth noting that if a $30 billion loss occurred during 2005, and the direct earned premium remained approximately the same for 2004 as it was for 2003 ($200 billion), then the insurers' deductible would be 15% of the $200 billion, or $30 billion, and the federal government would pay zero. So, another 9/11-size event in 2005 would not provide any federal funding for the insurance industry in this simplified example.

In reality, however, each insurer calculates its own deductible, based on its prior-year's direct earned premium, then submits 90% of the excess for federal reimbursement. In the example given of a $30 billion loss in 2004, it is highly unlikely that every single U.S. insurer would be on that risk. Therefore, the actual amount of federal participation would depend upon which insurers were impacted and what their individual deductibles would be (based upon their 2003 direct earned premiums). An extreme scenario would be that

[16] R. Glenn Hubbard and Bruce Deal, "The Economic Effects of Federal Participation in Terrorism Risk", September 14, 2004, http://www.analysisgroup.com/TRIA%20Report.pdf

only one or two major insurers would be hit with the loss, and therefore once their combined deductibles were exhausted, the federal portion of the loss could be significant. At the other extreme, if the loss affected most insurers, then the actual results would come close to the simple industry-wide example given. Another likely scenario is that most, if not all, insurers are hit with a loss, but that two major insurers have 90% of it. In that case, it would be likely that most insurers' losses would be within their deductible, but the federal share would be significant, due to 90% of the loss arising from only two insurers. Therefore, the distribution of the loss determines how much exposure there is for the federal government and the individual insurers.

It ts also important to note that the financial burden for individual companies may vary significantly, depending upon how much TRIA-related business they have relative to their total amount of capital. Here is a simplified example of how two different insurers would be impacted differently: one insurer with $200 million in TRIA-related "direct earned premium" and capital of $100 million, would have to pay approximately $21 million in losses, which represents 21% of its capital, before TRIA would pick up the rest.. Another insurer, with $200 million in TRIA-related premium and capital of $500 million, would also pay approximately $21 million in losses, but this represents only about 4% of its capital.

Total insured losses are covered up to $100 billion for each year that TRIA is in effect. TRIA is silent on what to do on the portion of certified losses that exceed $100 billion, if any. It is up to Congress to decide what happens at that point.

Total insured losses from an event covered under TRIA must exceed $5 million before the Act takes effect.

In addition, TRIA includes an exclusion of punitive damages from coverage under the program, and calls for federal, rather than state, jurisdiction in cases arising from the terrorist act.

What industries, besides insurance, are impacted most by TRIA?

TRIA was created to address pressing economic issues related to terrorism insurance availability. In the paper entittled "An Empirical Analysis of the Economic Impact of Federal Terrorism Insurance" (2004, Brown, Cummins, Lewis and Wei), the authors identified the industries most impacted by TRIA as follows:

1. Real Estate: There were two primary concerns raised for commercial property owners. The first was that, in the absence of a functioning insurance market, property owners would be required to bear the risk of terrorism losses themselves. Second, lenders typically require businesses to insure any property that is used to secure a loan. As such, in the absence of insurance, existing commercial properties might be more difficult to sell, thus creating liquidity problems and lowering prices.

2. Construction: Because lenders typically require insurance, concerns were voiced that new construction projects might not be able to secure financing, leading to delays or cancellations of projects.

3. Banking: Most banks require proof of insurance on properties as an on-going covenant on a loan. Banks do not want to assume terrorism risk on these properties, and therefore require this type of insurance. Without commercial insurance against terrorism risk, the banks would have the ability to claim "technical defaults" on the loans, giving them leverage over the property owners. As a result,

the unavailability of terrorism insurance would force banks to either waive these technical defaults and bear some of the terrorism risk themselves, or start accelerating payments and calling in loans.

4. Transportation: Especially due to the nature of the terrorist attacks of 9/11, there was great apprehension that, in the absence of insurance, railroads, trucking and shipping companies would be unable to transport many types of cargo or would face limitations on their destinations.

5. Utilities: In the aftermath of 9/11, serious concerns were raised about the vulnerability of power plants, particularly nuclear plants. The primary concern was that, absent insurance coverage, utilities would have to bear this risk, pass it along to consumers through higher prices, or scale back operations at vulnerable plants.[17]

When does TRIA expire?

TRIA expires on December 31, 2005. There is a discussion below of the administrative issues for both the insurers and commercial policyholders related to this expiration date.

What is the current status of the 2004 extension of the "make available" provisions?

On June 18, 2004, the Treasury Department announced its decision to extend the "make available" provisions of TRIA through 2005, the third year of the federal Terrorism Risk Insurance Program. The "make available" provisions require that each insurer must make available, in all of its commercial property and casualty insurance policies, coverage for losses due to covered acts of terrorism that does not differ materially from the terms, amounts and other coverage limitations applicable to losses arising from events other than acts of terrorism.

Although Treasury had until September 1, 2004 to determine whether or not to extend the "make available" provisions of TRIA, the determination was made well in advance of the deadline in order to avoid any potential disruption in the terrorism risk insurance market. In making this determination, Treasury was interested in the perspectives of both users and providers of terrorism risk insurance. To solicit input, Treasury published a request for comment with regard to the "make available" determination in the *Federal Register* on May 5, 2004. The request for comment addressed the effectiveness of TRIA on providing customers with offers of terrorism risk insurance that would otherwise have been unavailable, and whether the "make available" provision of TRIA had contributed to the affordability and availability of terrorism risk insurance. The comment period closed on June 4, 2004, and almost 200 comments were received.[18]

How is TRIA administered?

TRIA established the Terrorism Risk Insurance Program ("TRIP") within the Department of the Treasury. As of September 2003, Treasury had fully staffed the TRIP office. The office develops and oversees the

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[17] Brown, Jeffery, J. David Cummins, Christopher Lewis, Ran Wei, "An Empirical Analysis of the Economic Impact of Federal Terrorism Reinsurance," The Journal of Monetary Economics, Vol. 51, July 2004, pp.861-898

[18] Press release dated June 18, 2004 from the Treasury Department, http://www.treas.gov/press/releases/js1734.htm

operational aspects of TRIA, which encompass claims management—processing, review and payment—and auditing functions.

The TRIP staff consists of an executive director, a senior advisor, two attorneys, two policy analysts, and two administrative staff. Since becoming operational, TRIP staff have drafted regulations and performed other tasks necessary to make the program functional. For example, staff reviewed and incorporated appropriate public comments to proposed regulations and visited reinsurers to learn more about paying claims submitted by insurers as a prelude to developing criteria for claims payment and processing. Staff is also issuing contracts for vendors to supply these claims services.

Additionally, TRIP staff performs ongoing work such as issuing interpretive letters in response to questions submitted by the public and participating in conferences across the United States to inform regulators, industry participants and the public about TRIA provisions.[19]

How much do insurance companies pay for TRIA?

There is no up-front cost by the insurance companies to participate in the terrorism risk insurance program under TRIA, and participation is mandatory. There are, however, both mandatory and discretionary recoupment provisions in TRIA, as discussed below

What are the recoupment provisions of TRIA?

TRIA provides for mandatory recoupment of some or all of the federal share of losses, based upon a formula set out in TRIA. The complexity of the law's text has engendered a great deal of confusion, including inaccuracies in some publications. However, the underlying concept is relatively simple.

Two conditions must be met before mandatory recoupment occurs: (1) industry-wide losses must be less than the "insurance marketplace aggregate retention", as set forth below, and (2) individual insurers must have received federal reimbursement, due to losses which exceed their individual deductibles. If these two criteria are met, the federal government recoups some or all of its payments through policyholder surcharges. The amount that is subject to mandatory recoupment is calculated as follows: (1) the insurance marketplace retention, minus (2) the aggregate amount, for all insurers, of uncompensated losses (deductibles plus insurers' share of losses above the deductibles). Insurance marketplace aggregate retentions are set by year, as follows:

- For 2002 and 2003, $10 billion;
- For 2004, $12.5 billion;
- For 2005, $15 billion.

In the event that there is mandatory recoupment after a terrorism loss, this amount will be collected (over time, if necessary) as a policyholder premium surcharge set by the Secretary on all property and casualty insurance policies in force after a certain date, whether these policyholders had purchased TRIA coverage or

[19] Report by Richard J. Hillman, Director, GAO Financial Markets and Community Investment, to the Chairman, Committee on Financial Services, United States House of Representatives, April 2004

not. The surcharge will begin when the Secretary determines it is appropriate, and will be based on a percentage of the premium amount for the property and casualty coverage, not to exceed 3% of such premium amount per year. The insurers collect the surcharge amounts and remit them to the Secretary.

If, however, the insurers' aggregate amount of uncompensated losses exceeds the insurance marketplace retention, there is no mandatory recoupment.

To continue the simple industry-wide example above of insured losses of $30 billion in 2004, there would be no mandatory recoupment because the insurers' aggregate uncompensated losses total $21 billion, and this amount exceeds the marketplace retention for that year of $12.5 billion.

The case is different, however, if losses were not spread proportionately across all insurers, but were concentrated in a subset that had a total of only $10 billion of TRIA deductibles. The federal government would pay $18 billion (90% of the $20 billion excess over the deductible), leaving $12 billion of uncompensated industry losses. The government would recoup $.5 billion, the $12.5 billion marketplace retention minus the $12 billion of losses already absorbed by the insurers.

In addition, the Treasury Secretary has the discretion to demand additional recoupment, taking into account the following factors:

the ultimate cost to taxpayers of no additional recoupment;

the economic conditions in the commercial marketplace, including the capitalization, profitability, and investment returns of the insurance industry and the current cycle of insurance markets;

the affordability of commercial insurance for small- and medium-sized businesses; and

such other factors as the Secretary considers appropriate.[20]

In other words, the Treasury Secretary *could* choose to recoup 100 percent of federal outlays under this program through *ex post* premium surcharges.

What are some of the administrative issues related to the December 2005 expiration date of TRIA?

Unlike reinsurance contracts, the renewal dates of which are heavily concentrated in January, renewals of primary insurance contracts are spread more uniformly throughout the year. TRIA's "hard" expiration date presents some administrative problems for insurers. At the primary insurance policy level, if an insurer writes a policy in February 2005 that provides TRIA coverage and has a loss in January 2006, the federal government will not provide compensation, even though the "make available" provisions of TRIA are in effect now for policies issued in 2005. In addition, the underwriting process for commercial coverages begins several months prior to the actual renewal date of the policies, so the uncertainty about the status of TRIA beyond December 2005 will impact the primary insurance industry much earlier, even as soon as the fourth quarter of 2004.

[20] TRIA legislation, Sec. 103 (7)(D)

The uncertainty in the insurance marketplace over whether TRIA will be extended or not creates problems for both insurers and policyholders as 2005 approaches and policies issued after January 1, 2005 run the risk of not having TRIA available for the full 12 months the policy is in force. The Insurance Services Office (ISO), an industry service organization, has filed conditional terrorism insurance policy endorsements with state insurance regulators should Congress not extend TRIA beyond its December 31, 2005 end date. These optional, conditional endorsements will be available for use on policies with terms that extend beyond December 31, 2005. The endorsements provide participating ISO insurers several options, including:

a total exclusion of losses from acts of terrorism;

an exclusion for losses resulting from acts involving nuclear, biological or chemical terrorism; and

a means to cover terrorism losses not otherwise excluded up to a sublimit (a lesser amount than the full policy limit).

If TRIA expires, the terms of the endorsements become applicable on January 1, 2006, and would apply to any losses that occur on or after that date. The endorsements will also take effect if the backstop is extended but increases insurers' share of losses or risk of loss from terrorism events. The filing of these conditional endorsements was announced on May 3, 2004 to give insurers sufficient time to make any necessary changes in their operational systems.[21]

[21] ISO press release dated May 3, 2004, http://www.iso.com/press_releases/2004/05_03_04.html

GLOSSARY

Actuary: A specialist in the mathematics of insurance who calculates rates, reserves, dividends and other statistics.

Adverse Selection: The tendency of those exposed to a higher risk to seek more insurance coverage than those at a lower risk. Insurers generally react either by charging higher premiums or not insuring at all. In the case of natural disasters, such as earthquakes, adverse selection concentrates risk instead of spreading it. Insurance works best when risk is shared among large numbers of policyholders.

Aggregate Limit: Indicates the amount of coverage that the insured has under the contract for a specific period of time, usually the contract period, no matter how many separate accidents might occur.

Assets: Assets for an insurer refer to "all the available properties of every kind or possession of an insurance company that might be used to pay its debts."

Balance Sheet: Provides a snapshot of a company's financial condition at one point in time. It shows assets, including investments and reinsurance, and liabilities, such as loss reserves to pay claims in the future, as of a certain date. It also states a company's equity, known as policyholder surplus. Changes in that surplus are one indicator of an insurer's financial standing.

Business Income Insurance (also known as **Business Interruption Insurance**)**:** Commercial coverage that reimburses a business owner for lost profits and continuing fixed expenses during the time that a business must stay closed while the premises are being restored because of physical damage from a covered peril, such as fire. Business interruption insurance also may cover financial losses that may occur if civil authorities limit access to an area after a disaster and their actions prevent customers from reaching the business premises.

Capacity: The supply of insurance available to meet demand. Capacity depends on the industry's financial ability to accept risk. For an individual insurer, it is the maximum amount of risk it can underwrite based on its financial condition. The adequacy of an insurer's capital relative to its exposure to loss is an important measure of solvency.

A property/casualty insurer must maintain a certain level of capital to underwrite risks. The amount of capital determines how much business it can underwrite, known as its capacity. When the industry is hit by high losses, such as after the 9/11 attacks, capacity is diminished. It can be restored by increases in net income, favorable investment returns, reinsuring more risk and or raising additional capital. When there is excess capacity, usually because of a high return on investments, premium rates tend to decline as insurers compete for market share. As rates decline, underwriting losses are likely to grow, reducing capacity and causing insurers to raise rates and tighten conditions and limits in an effort to increase profitability.

Capital: Shareholder's equity for stock insurers and retained earnings for mutual insurers. The company's capital is measured by the difference between its assets and liabilities. This value protects the interests of the company's policyholders in the event it develops financial problems. From a regulatory point of view, shareholders' interests are secondary to policyholders' interests.

Casualty Insurance: That type of insurance that is primarily concerned with losses caused by injuries to persons and legal liability imposed upon the insured for such injury, or for damage to property of others.

Catastrophe: Term used for statistical recording purposes to refer to a single incident or a series of closely related incidents causing severe insured property losses totaling more than a given amount, currently $25 million.

Catastrophe Model: Using computers, a method to mesh long-term disaster information with current demographic, building and other data to determine the potential cost of natural disasters and other catastrophic losses for a given geographic area.

"Certified" Acts of Terrorism: as defined in TRIA, "certified" acts of terrorism are committed by foreign persons against interests in the U.S. or against certain U.S. interests overseas.

Claim: A demand made by the insured, or the insured's beneficiary, for payment of the benefits of an insurance policy. The dollar amount of a claim is often referred to as a "loss" by insurers.

Commercial Lines: Refers to insurance for businesses, professionals and commercial establishments. Among the major coverages are boiler and machinery, business interruption, commercial auto, comprehensive general liability, directors and officers liability, fire and allied lines, inland marine, medical malpractice liability, product liability, professional liability, surety and fidelity, and workers compensation. Most of these commercial coverages can be purchased separately except business interruption which must be added to a fire insurance (property) policy.

Commissioner of Insurance: The title of the head of most state insurance departments. In some states, the title Director or Superintendent of Insurance is used instead.

Coverage: The scope of protection provided under an insurance policy.

Covered Loss: Illness, injury, death, property loss, legal liability, or any other situation or loss for which an insurer will pay benefits under a policy when such event occurs.

Deductible: The portion of an insured loss to be borne by the insured before he is entitled to recovery from the insurer. Usually it is either a specified dollar amount or a percentage of the claim amount.

Earned Premium: The portion of the premium that applies to the expired part of the policy period (usually one year). Insurance premiums are payable in advance but the insurer does not fully earn them until the policy period expires.

Economic Loss: Total financial loss resulting from (1) the death or disability of a wage earner, or (2) from the destruction of property. Includes the loss of earnings, medical expenses, funeral expenses, the cost of restoring or replacing property, and legal expenses. It does not include noneconomic losses, such as pain caused by an injury.

Effective Date: The date on which the protection of an insurance policy goes into effect.

Exclusion: A provision in an insurance policy that eliminates coverage for certain risks, people, property classes, or locations.

Experience: Record of losses for an insurer, or for the insurance industry as a whole, on either an individual policy, or line of business, or overall.

Exposure: Measure of vulnerability to loss, usually expressed in dollars or units.

File-and-Use Rating Laws: State-based laws which permit insurers to adopt new rates without the prior approval of the insurance department. Usually insurers submit their new rates with supporting documentation.

General Liability Insurance: Insurance designed to protect business owners and operators from a wide variety of liability exposures. Exposures could include liability arising from accidents resulting from the insured's premises or operations, products sold by the insured, operations completed by the insured, and contractual liability.

Incurred Losses: The losses occurring within a fixed period, whether or not adjusted or paid during the same period.

Insurable Risk: Risks for which it is relatively easy to get insurance and that meet certain criteria. These include being definable, accidental in nature, and part of a group of similar risks large enough to make losses predictable. The insurer also must be able to come up with a reasonable price for the insurance.

Insurance: A system to make large financial losses more affordable by pooling the risks of many individuals and businesses and transferring them to an insurance company in return for a premium.

Insurance Department: In the U.S., a governmental bureau in each state charged with the administration of insurance laws, including the licensing of agents and insurers and their regulation and examination. In some jurisdictions the department is a division of another state department or bureau.

Insurance to Value: Insurance written in an amount approximating the value of the property insured.

Insured: The party to an insurance agreement whom the insurer agrees to indemnify for losses, provide benefits and render services to.

Insurer: The party to an insurance agreement who undertakes to indemnify for losses, provide pecuniary benefits and render services.

Limits: Maximum amount of insurance that can be paid for a covered loss.

Line: Type or kind of insurance, such as personal lines or commercial lines.

Loss: Generally refers to (1) the amount of reduction in the value of an insured's property caused by an insurable event, (2) the amount sought through an insured's claim, or (3) the amount paid on behalf of an insured under an insurance contract.

Loss Frequency: Number of times a loss occurs. One of the criteria used in calculating premium rates.

Loss Reserve: The estimated liability, as it appears in an insurer's financial statement, for unpaid insurance claims or losses that have occurred as of a given evaluation date. For individual claims, the loss reserve is the estimate of what will ultimately be paid out on that claim.

Loss Severity: The dollar amount of a loss. One of the criteria used in calculating premium rates.

"Make Available" Provisions: In TRIA, these require that each insurer must make available, in all of its commercial property and casualty insurance policies, coverage for losses due to covered acts of terrorism that does not differ materially from the terms, amounts and other coverage limitations applicable to losses arising from events other than acts of terrorism.

National Association of Insurance Commissioners (NAIC): An association of state insurance commissioners formed for the purpose of exchanging information and of developing uniformity in the regulatory practices of the states through drafting model legislation and regulations. The NAIC has no official power to enforce compliance with its recommendations.

Occurrence: An event that results in an insured loss.

Personal Lines: Property/casualty insurance products that are designed for and bought by individuals, such as homeowners and automobile policies.

Policy: A written contract for insurance between an insurance company and policyholder stating details of coverage.

Premium: The price of an insurance policy for a given period of time, usually one year.

Property/Casualty Insurance: Covers damage to or loss of policyholder's property, and legal liability for damages caused to other people or their property. Property/casualty insurance is one segment of the insurance industry (the other is life/health). It includes auto, homeowners and commercial insurance. Outside the United States, property/casualty insurance is referred to as nonlife or general insurance.

Rate: The cost of a unit of insurance, usually per $1000 of coverage. Rates are based on historical loss experience for similar risks and may be regulated by state insurance departments.

Reinsurance: Insurance bought by insurers. A reinsurer assumes part of the risk and part of the premium originally taken by the insurer, known as the primary company. Reinsurance effectively increases an insurer's capital and therefore its capacity to sell more coverage. The business is global and some of the largest reinsurers are based abroad. Reinsurers have their own reinsurers, called retrocessionaires. Reinsurers don't pay policyholder claims directly; they reimburse the insurers for claims paid.

Reserves: (See "Loss Reserves").

Risk: The chance of loss for the person or entity that is insured, or the specific event for which the policyholder is insured.

Solvency: Insurance companies' ability to pay the claims of policyholders. Regulations to promote solvency include minimum capital and surplus requirements, statutory accounting conventions, limits to insurer's investment and corporate activities, financial ratio tests, and financial data disclosure.

Standard Policy: (1) Coverage which has identical provisions regardless of the issuing insurer. Many common policies are standardized. (2) Insurance issued to a standard, or "average", underwriting risk.

Stand Alone Terrorism Insurance: Terrorism insurance coverage offered by insurers which is not subject to the terms and conditions under TRIA. Such coverage may offer broader terms, such as coverage for both foreign and domestic acts of terrorism, as well as coverage for locations outside of the U.S. 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 insurance company offer terrorism insurance to its commercial policyholders.

Sublimit: Any limit of insurance which exists within another limit. For example, special classes of property may be subject to a specified dollar limit per occurrence, even though the policy has a higher overall limit.

Surety Bond: A contract guaranteeing the performance of a specific obligation. It is a three-party agreement under which one party, the surety company, answers to a second party, the owner, creditor, or "oblige", for a third party's debts, default or nonperformance. Contractors are often required to purchase surety bonds if they are working on public projects. The surety company becomes responsible for carrying out the work or paying for the loss up to the bond "penalty" if the contractor fails to perform.

Surplus Lines: Property/casualty insurance coverage that isn't available from insurers licensed in the state, called admitted companies, and must be purchased from a non-admitted carrier. Examples include risks of an unusual nature that require greater flexibility in policy terms and conditions than exist in standard forms or where the highest rates allowed by state regulators are considered inadequate by admitted companies. Laws governing surplus lines vary by state.

Terrorism Coverage: Included as part of the package in standard commercial insurance policies before September 11, 2001, virtually free of charge. Since September 11, terrorism coverage is priced and sold separately, either under the terms of TRIA, or as Stand Alone coverage.

Terrorism Risk Insurance Act of 2002 (TRIA): 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 insurance company offer terrorism insurance to its commercial policyholders.

Underwriting: The process of selecting risks for insurance and classifying them according to their degrees of insurability so that the appropriate rates may be assigned. The process also includes rejection of those risks that do not qualify.

Underwriting Income: The insurer's profit (or loss) on the insurance sales after all expenses and losses have been paid. When premiums are not sufficient to cover claims and expenses, the result is an underwriting loss. Investment income is not included in this amount.

Workers Compensation: Insurance that pays for medical care and physical rehabilitation of workers injured on the job, and helps to replace lost wages while they are unable to work. State laws, which vary significantly, govern the amount of benefits paid and other compensation provisions.

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