HOMELAND SECURITY POLICY INSTITUTE

Executive Brief

Terrorism Risk Insurance: Assessing TRIA and the Way Forward

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Issue

The Terrorism Risk Insurance Act (TRIA) of 2002 is set to expire on December 31, 2005. It is vital that government leaders now reassess the Act and the future of terrorism risk financing, including the role of the federal government, if any, in this field.

Background

In response to claims in the order of $40 billion[1] generated by the attacks of September 11, 2001, Congress enacted Public Law 107-297, which was signed by President Bush at the end of 2002. That legislation, known as "TRIA", requires insurers to offer terrorism coverage to their commercial policy holders and provides a federal backstop to the insurance industry. More specifically, the Act requires the Department of the Treasury to oversee a program designed to provide short-term support to the private insurance market. By legislating in this area, Congress recognized that measuring the risk of a terrorist attack was relatively new to the insurance industry. Underpinning the Act, however, was the understanding that a robust private insurance market would emerge and, in future, provide a foundation for financial recovery in the event of another terrorist attack on the homeland.

The events of 9/11 placed the economic future of insurers in peril. Before 9/11, terrorism constituted "an unnamed peril" covered by most standard "all-risk" policies at no additional cost.[2] By 2002, however, the vast majority of States had authorized insurance companies to exclude terrorism protection from all of their policies, with the exception of workers' compensation coverage (re: occupational injury without regard to the peril that caused the injury). With TRIA, the federal government stepped into the breach.

Under the Act, industry pays 100 % of property and casualty losses below $5 million, caused by a terrorist attack committed by or on behalf of foreign persons or interests within the United States. Federal cost-sharing kicks in at the stated threshold, with the US Treasury to absorb 90% of the losses over and above the company's deductible (calculated in 2005 as 15% of an insurer's premiums earned in calendar year 2004). The total federal contribution is capped by law at $100 billion per year, with congressional discretion to be exercised vis-à-vis losses in excess of that amount. Recoupment provisions also set out a framework for federal recovery in the event that aggregate industry losses fall below set figures in particular years ($15 billion in 2005). Notably, TRIA applies to commercial lines of property and casualty insurance, including workers' compensation insurance. Initially, high premiums resulted in low take-up rates in the general commercial market. Over time, and in the absence of further attack(s) on US soil, premiums in that market have declined significantly, with expected effect upon take-up rates. By contrast, rates have remained high in specialty or high risk markets. On average, however, half of commercial enterprises have purchased terrorism coverage.

As the expiry of TRIA draws near, both chambers of Congress have passed bills calling for an extension of the Act, thereby continuing coverage for insured losses through till December 31, 2007. Both the House and Senate versions of the bill would raise the threshold for federal risk-sharing by many orders of magnitude --- to $50 million in 2006 and $100 million in 2007. Likewise, under both versions of the bill, insurers' deductibles would rise. In addition, the level of federal co-payments would either decrease over time (Senate version) or vary in connection with the severity of the event (House version). Notably, the House proposal calls for CBRN (chemical, biological, radiological and nuclear) attack coverage, and would also remove the distinction between foreign and domestic acts of terrorism (so that domestic terrorism would be covered). Further, the House would establish a public-private commission to draft specific recommendations regarding, inter alia, reducing the role of the federal government in this area. By comparison, the Senate would have the Presidential Working Group on Financial Markets, in consultation with policy holders, the insurance and securities industries, and the National Association of Insurance Commissioners, report to Congress no later than September 30, 2006, on the long-term availability and affordability of terrorism insurance.

Key Findings

- As TRIA sunsets, "nothing is not an option," for the legislation affects a broad range of social, economic and political policies, and a number of different parties, over and above insurers. Without the Act, significant economic engines such as commercial construction would be negatively impacted by spillover effects which, in turn, would negatively affect job-creation and job-retention rates.

- While the Act does serve to protect the insurance industry from catastrophic loss, that is not --- and ought not to be --- its fundamental underlying purpose. In pithy terms, TRIA should exist to enhance security for the American people and our infrastructures including critical components, its owners and operators, and commercial real estate more generally.

- In the absence of TRIA, we would expect premiums to increase significantly and take-up rates to decline accordingly.

- If, however, TRIA were to remain in place indefinitely, particularly as currently structured and worded, there would be little incentive for the insurance industry to step forward and ease the disproportionate burden presently being borne by the federal government (and, by extension, taxpayers). At the same time, there would be little incentive for owners and operators of our infrastructures to bolster security and thereby lower their insurance costs (by adopting best practices).

- While the federal government is, and must continue to be, a valued partner to industry, government is best suited to act as insurer of last resort in a genuinely catastrophic context. Accordingly, the respective roles of government and industry in the area of terrorism risk insurance should be defined with the greatest of care.

- Under TRIA, significant gaps in coverage exist:

    - The legislation does not cover acts of terrorism perpetrated by domestic entities. Yet domestic threats do exist. Consider, for example, the Oklahoma City bombing. Likewise, Al Qaeda has been known to "franchise" terrorist attacks to local affiliates. Homegrown threats, such as Al Qaeda sleeper cells including US citizens, must not be wholly discounted. The July 2005 bombings in London demonstrate the nexus between domestic and international terrorism.

    - TRIA does not direct insurers to offer coverage against a CBRN attack. Indeed, very few companies offer CBRN coverage at any price. Yet, this type of event could bring cities, businesses, and critical infrastructure to an immediate halt.

    - Group life insurance is also omitted from the rubric of the Act.

- Congressional and executive branch oversight of this issue area is fractured and insufficiently robust.

    - As things now stand, the House Financial Services and Senate Banking Committees have jurisdiction over terrorism risk insurance, but the House and Senate Homeland Security Committees do not. The House and Senate Judiciary Committees are similarly excluded, as are the House and Senate Committees on Intelligence. This division of jurisdiction is akin to putting a company's Chief Financial Officer in charge of corporate security and having him try to accomplish that task without the benefit of the Chief Security Officer's knowledge and expertise. Plainly, this would not be the most effective way to get the job done.

    - Within the executive branch, the "point-person" on terrorism risk insurance is situated in the Treasury Department. Robust crosswalks to other concerned departments, including Homeland Security, have yet to be built. Likewise, within the White House itself, the Homeland Security Council has yet to be fully integrated into planning and policy in this area.

- The future availability and affordability of terrorism risk insurance is a matter of national importance. As such, the subject merits study by a non-partisan group of experts. All relevant perspectives must be represented at the table if the exercise is to produce an optimal outcome.

Recommendations

Short Term Action

- **Extend TRIA for a two-year period**

As the House and Senate bills propose, TRIA should be extended for a two-year period. This will allow the insurance (and reinsurance) industry to build a stronger foundation designed to take on more of the risk in this field.

- **Calibrate incentives to encourage industry to serve the public interest**

As a corollary to the two-year extension of TRIA, we should calibrate incentives to encourage both insurers and reinsurers to step up to the plate and do so in a way that serves the public interest. With proper incentive mechanisms, the market in this domain could become more robust and industry would be more inclined to step forward and free up the federal government to fulfill the role that it is best suited to play: namely, that of insurer of <u>last</u> resort in a genuinely catastrophic context.

- **Address gaps and shortfalls in existing legislation**

Throughout, our goal must be to keep premiums to a reasonable level, without sacrificing (policy holders') extant coverage, and to address gaps and shortfalls in existing legislation. At a minimum, this means that coverage should be introduced for CBRN events and for domestic acts of terrorism. Serious consideration should also be given to the inclusion of group life insurance within the rubric of the (successor) Act.

- **Bolster congressional and executive branch oversight**

    - It is incomplete to leave jurisdiction over terrorism risk insurance solely to the House Financial Services and Senate Banking Committees, particularly as mechanisms and processes are introduced to shift the onus in this field more towards the private sector. Thorough and beneficial congressional oversight is enhanced if the House and Senate Committees on Homeland Security, Intelligence, and the Judiciary, share in that jurisdiction. The analogy invoked above is apt: just as a company's Chief Financial Officer should not try to achieve corporate security without the benefit of the Chief Security Officer's knowledge and expertise, so too should the above-listed House and Senate Committees be involved in an integral way where terrorism risk insurance is concerned.

    - To remedy structural or institutional gaps that exist on the executive side, robust crosswalks should be built to link the Treasury Department to other relevant departments, including Homeland Security. In addition, within the White House itself, we should create a Deputy Assistant position to advise the President on matters of joint concern and relevance to the Homeland Security Council and the National Economic Council. The individual holding this position would be double-hatted and would marry up subject-matter expertise in the fields of both terrorism and economics/finance. The creation of this new position would benefit the President by offering him a valuable source of multidisciplinary, synthesized advice.

- **Create a non-partisan congressional commission to examine terrorism risk insurance**

A non-partisan congressional commission should be formed to examine terrorism risk insurance and facilitate the transfer of additional responsibility in this area from the federal government to the insurance industry. Among other things, the commission would report on ways and means of expanding the availability, and encouraging the affordability, of this type of insurance.

  - The work of the commission should be time-limited, with specific goals to be achieved according to pre-defined timelines. The commission's final report must be submitted to Congress at least one year before any successor legislation to TRIA expires.

  - The work of the commission must reflect and incorporate a range of perspectives. The input of all relevant stakeholders must be solicited and integrated if the exercise is to be effective. With respect to the federal level, the views of the Departments of the Treasury, Homeland Security, and Justice (FBI), and those of the Intelligence Community, must be sought. Equally, the State and local levels including law enforcement, emergency managers and chief accounting officers, must be consulted. Similarly crucial is input from the private sector including representatives of the insurance and re-insurance industries, owners and operators of critical infrastructure, economists and risk managers, and (outside) experts on homeland security.

Medium to Long Term Action

- **Build the Business Case for Homeland Security**

Over the medium to long term, and looking beyond just TRIA (or its possible successor) alone, we should turn our minds to building the business case for homeland security taken broadly. A successful business case would incorporate the following elements[3]:

- Public-private information sharing and delineation of roles
- Analysis and assessment of threats, risks and vulnerabilities
- Identification of the secondary and tertiary benefits of security

- Highlighting of best practices and standards/guidelines
- Oversight by government and/or trusted third party
- Carefully designed metrics that ensure progress
- Government and market-based rewards and incentives for security
- Regulations, as a last resort

Using this model as a foundation, government and industry could each play to their respective strengths and, together, strive to mitigate both risk and consequences.

Conclusion

The impact of the threat of terrorism on the economy of the United States is not yet fully understood. Changes in insurance markets may ripple through the economy in ways not always clearly apparent. As such, these changes could result in significant economic dislocation.

Against this background, government is, and must continue to be, a valued partner to the insurance industry. But, as outlined and emphasized above, we must define the respective roles of government and industry in this area with the greatest of care.

TRIA has served as a post-9/11 "band-aid" solution. The crucial question, however, is: "Where do we go from here?" TRIA must surely be extended, but we must get it right both in terms of the larger strategy underpinning any successor legislation and also the important details surrounding its implementation.

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[1] The cited figure regarding claims is derived as follows: $33 billion (insured losses) and $7 billion (approximately, paid by the federal government through the Victim Compensation Fund).

[2] Howard Kunreuther and Erwann Michel-Kerjan, "Terrorism Insurance 2005: Where Do We Go From Here?" *Regulation* (Washington, DC: The Cato Institute), vol. 28, no. 1, p. 44 (Spring 2005).

[3] See also Frank J. Cilluffo, "Preventing Terrorist Attacks on America's Chemical Plants," Testimony before the Subcommittee on Economic Security, Infrastructure Protection and Cybersecurity, Committee on Homeland Security, U.S. House of Representatives, delivered on June 15, 2004.

Note: This Executive Brief follows on from (ongoing) work by the authors and discussions that took place at the Roundtable on TRIA, organized and hosted by the Homeland Security Policy Institute, on October 28, 2005. *The co-authors take full responsibility for the opinions and recommendations herein.*

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About the Institute

The Homeland Security Policy Institute (HSPI) draws on the expertise of The George Washington University and its partners from the academic, non-profit, policy and private sectors for a common goal of better preparing the nation for the threat of terrorism. HSPI frames the debate, discusses policy implications and alternatives and recommends solutions to issues facing America's homeland security policymakers. By linking academicians and scientists to decision makers and practitioners at all levels of government, the private sector and the communities we live in, HSPI is working to build a bridge between theory and practice in the homeland security arena.

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