Legal Backgrounder

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LACK OF TERRORISM REINSURANCE THREATENS ECONOMIC RECOVERY

by

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In the wake of the September 11, 2001 attacks, Congress considered creating a federal backstop, allowing insurers time to adapt to the new realities of terrorism. One of the driving motivations for immediate action was the concern that serious problems would arise for insurers in 2002 after their reinsurance coverage had expired. Reinsurers carry a portion of the primary insurers' risk, making the risk load manageable. Since reinsurers are not regulated to the same extent as primary carriers, they are not required to have regulatory approval of their exclusions or contract language with their ceding companies. On the other hand, primary insurers must seek authority to exclude terrorism losses from each state's insurance regulator. It was feared that reinsurers would exclude terrorism coverage and primary insurers would either be allowed to exclude terrorism coverage, leaving policyholders without critical coverage, or would not be permitted to use this exclusion, leaving them covering risks that they could not manage alone. Although Congress did not adopt a federal reinsurance backstop at the end of last year, policymakers at the federal and state level are examining the issue anew.

While no immediate crisis has confronted insurers since January 1, 2002, it is clear that one is looming. Reinsurers are raising rates and excluding acts of terrorism. Primary insurers are responding either by non-renewing, excluding terrorism coverage where possible, or by limiting primary coverage amounts. The result — risks above the available insurance limits are left without insurance coverage for terrorism. The crisis begins with these uncovered risks but as time goes on its effects will be felt throughout our economy.

All these factors can only lead to one conclusion: The lack of a federal backstop will ultimately have a stultifying effect on our economy and any possible economic recovery. A review of recent developments, and their implications, illustrates this point further.

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Terrorist Acts Have Been Excluded in Reinsurance Arrangements

The majority of reinsurance arrangements between primary property and casualty insurance companies and reinsurers were renewed on January 1, 2002. As a result of the World Trade Center ("WTC") attack of September 11, 2001, reinsurers, for the most part, have insisted upon a number of new restrictions and significant rate increases on contracts negotiated after September 11th. Some of these are as follows:

- Exclusions for terrorist acts became standard in virtually every property and casualty reinsurance treaty. Considering that a number of large reinsurers have incurred significant losses from the WTC attack, some in excess of $2 billion, this response is not surprising. In addition, significant rate increases were required by reinsurers, despite the fact that they have excluded terrorist acts.
- The diminished availability of reinsurance translates to reduced capacity available to primary risks. This is particularly true in densely populated urban areas. Before September 11th this was not a problem, and ample reinsurance capacity was available in the marketplace.
- Requests were made by many reinsurers for new underwriting guidelines to reduce the exposure to terrorism, such as: (1) placing restrictions on the size and total insurance value of buildings that were acceptable to the reinsurers, typically no more than $50 million; (2) prohibiting coverage on any building that can be considered a target risk such as the Empire State Building, Met Life Building, Carnegie Hall, Madison Square Garden etc.; (3) requiring the tracking of risk accumulations to avoid writing business that was in close proximity to target buildings and avoid accumulations of risks by specific location and zip code; and (4) limiting the writing of Workers' Compensation policies in Manhattan or any urban area for concentrations at a single location of more than a specific number of employees.
- Exclusions for mold also became standard in property and casualty treaties. While not related to terrorism, this new exclusion added to the challenges facing insurers and their policyholders.
- Finally, the significant increase in reinsurance rates in an increasingly difficult market forced many primary insurers to substantially raise their rates, particularly in densely populated urban areas. Rates on renewal policies have increased 30% or more, and rate increases on new business are even higher.

A small number of reinsurers providing both limited capacity for property business and a separate type of the coverage for casualty business at excessively high rates began offering a new form of stand-alone terrorist reinsurance. Premiums for this reinsurance were in addition to the increased cost of the traditional reinsurance coverage effective on or after January 1, 2002. While this provided some coverage for terrorist losses, the cost of the coverage limited the amount that was affordable. This, in no way, served to close the expanding coverage gap.

Without the availability of terrorism reinsurance at affordable rates, there is concern that another terrorist event could render a primary carrier without the coverage insolvent. Therefore, many carriers

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have had no choice but to refuse to renew their large commercial property and workers' compensation accounts, or reduce their limits of coverage to levels below what was needed. Further, it became necessary for primary carriers to significantly increase their rates for commercial insurance to cover the increased cost of reinsurance. Although most state regulators approved the ISO filing of the terrorism exclusion, not all did. Regardless, with the approved exclusion, the trigger to exclude terrorism required terrorist claims to exceed $25 million, which was more exposure than most carriers could reasonably assume.

On the property side, most primary companies, other than the largest national companies, could not insure buildings with total insurance values in excess of $50 million. While insurers will not experience a crisis by refusing to write the coverage, unfortunately, the same cannot be said for some policyholders. Many commercial office building in New York City with values that exceed $50 million and go as high as $300 million will be left with inadequate coverage or no coverage at all. In fact, some smaller insurers are refusing to provide coverage above a $20 to $25 million-dollar exposure. At present, there is a clear and growing gap in commercial property insurance coverage that the private markets cannot cover.

Workers' compensation coverage will also create substantial challenges. Insurers will be required to track accumulations of risk to avoid providing coverage in unacceptable urban areas, or for concentrations of employees perceived as unacceptable. When the average workers' compensation death benefit, depending upon the jurisdiction, can be $300,000 to $500,000, insurers face a substantial loss providing coverage for high concentrations of employees. Like real estate, there is a widening gap between available insurance and employers' needs.

The problem is that insurers are incapable of assuming infinite risk and the ability to spread risk has been substantially impaired by the lack of reinsurance. The stewardship of a primary company obligates it to adapt to new circumstances so that its financial strength is maintained. Since September 11th, those new circumstances have forced insurers to provide less coverage to their customers. This is particularly true for insurers, like GNY Insurance Companies, that provide commercial coverage in densely populated urban areas. Without reinsurance coverage, these problems will continue to grow.

Impact on Owners of Real Estate and the Business Community

These limitations are already affecting our policyholders in the following ways:

- Pricing of primary policies effective in 2002 increased dramatically, in some cases increases of 100% or more.

- Many mortgage agreements are in breach of contract since many policies are now limited by terrorist exclusions.

- Lenders and mortgages are highly concerned about the lack of coverage for acts of terrorism. This concern will make it increasingly difficult to obtain new mortgages for new projects.

- There is a possibility that many of New York City's rent stabilized buildings may be pushed towards insolvency. Rent stabilization limits profits, so that property owners

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have less money with which to buy insurance. Consequently, even if they can obtain insurance, they may not be able to pay for it at the new prices.

- Significant increases in insurance costs will be passed on to the consumer where possible, which will put a damper on the economic recovery.

Conclusion

There is a growing gap between available insurance and the actual risk that must be covered. This gap is created by the uncertainty surrounding terrorism. Before September 11th, the possibility of an attack that would completely destroy the twin towers of the World Trade Center was considered either paranoid fantasy or the subject of a Hollywood script. It was certainly never considered as a realistic threat by anyone in industry or government. Recently captured video tapes show that even the terrorists did not believe that the buildings would collapse.

The insurance industry has not had the time it needs to consider and understand this terrible new risk. This lack of information has led to uncertainty, and that uncertainty has resulted in a gap between available insurance and existing risk. Insurers want to find a way to protect policyholders. However, four months is clearly not enough time. There needs to be time to adapt. The only entity with sufficient resources to ameliorate this risk is the federal government. The continued lack of a federal backstop for future terrorist losses will have a serious negative impact on the anticipated economic recovery this year.

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