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TERRORISM RISK INSURANCE EXTENSION: MAINTAINING COMPETITIVE BALANCE

by

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Introduction. Extension of the Terrorism Risk Insurance Extension Act (TRIA), scheduled to expire on December 31, 2007, is one of the most important issues facing the property/casualty insurance industry this year. Beginning this year, policies have been written that do not carry federal terrorism reinsurance protection throughout their term, leaving policyholders unprotected and creating unnecessary uncertainty.

Extending or replacing TRIA is critical to the insurance industry, its policyholders, and those they serve. Every review conducted by the U.S. Treasury, the U.S. General Accountability Office (GAO), and other analysts has concluded that there has been no development of any significant private market supply for terrorism insurance and reinsurance coverage since 9/11. It is simply unbelievable that sufficient private market capacity will develop to replace the protection now provided by the Federal government. Letting the TRIA program expire without replacement places at tremendous risk the financial security of those who depend on their insurance coverage for protection. Moreover, providing insurance protection against a terrorist attack is a matter of national economic security and an obligation of the government itself.¹

An aspect of the program's design that has been little discussed to date is its impact on the competitive balance of the industry. Certain TRIA design features can have significant effects on the competitive balance of the industry which, in turn, can have negative impacts on policyholders. A key principle guiding the design of a future program should be to maintain industry competitive balance. Unlike other risks assumed by insurers and private capital markets, terrorism is unavoidably and irrevocably tied to government policy itself and the policy response should not fundamentally alter the industry's structure.

Significant Agreement on Key Principles. Throughout discussions about the renewal of TRIA, it has been clear that there is significant agreement among most observers about key principles for a future program. These include:

¹In an excellent recent article, "National Security and Private-Sector Risk Management for Terrorism," Rand Corporation economists Lloyd Dixon and Robert Reville point out the fundamental differences between terrorism risk and other risks normally insured by the private insurance industry. They argue that "Risk management and compensation policies for terrorism have national security implications, and these implications should be considered in designing such policies." They point in particular to the importance of policies that "...address the vulnerability and resilience of the economy to attack." "National Security and Private-Sector Risk Management for Terrorism", in "*Seeds of Disaster, Roots of Response: How Private Action Can Reduce Public Vulnerability*", 2006, edited by Auerswald, Branscomb, LaPorte, and Michel-Kerjan.

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- Recognize that TRIA is an essential part of our national security efforts against the threat of terrorism.
- Recognize the integral role that TRIA has played in making terrorism insurance available and affordable to America's large and small businesses.
- Recognize that absent a Federal backstop the market for terrorism insurance would be virtually nonexistent.
- Recognize that a strong Federal role in terrorism insurance protection must continue, even as we work to reduce the Federal responsibility gradually over time.
- Ensure that all potential victims of terrorist attacks, regardless of the source of an attack, have access to terrorism insurance protection.
- Ensure that all acts of terrorism are covered.
- Ensure that robust competition in the marketplace for terrorism insurance continues without disruption.

With respect to the future program structure, there is considerable agreement. Important consensus design elements include:

- Maintain a TRIA-type structure in the future, as an individual insurer reinsurance program.
- Focus the program on the lines of business that have been covered in the program from the beginning, with some adjustments where needed.
- Protect against all types of terrorist attacks and both foreign and domestic-inspired acts of terrorism. There is no logical basis to cover one type of terrorist attack, but not another, or to exclude domestic acts of terrorism from coverage, especially when it may be impossible after an act of terror to determine its ultimate source. The uncertainty regarding the availability of reinsurance in such a circumstance does not serve consumers' best interests or the interests of sound public policy.
- Establish the program on a long-term basis. There is no benefit to be served (and much to be lost) by having to go through the ongoing uncertainty of whether the program will exist in the future.
- Provide program triggers and deductibles that make the program accessible to all insurers writing TRIA-covered lines of business.

Effects of the Program on Small and Medium-Size Insurers. This analysis is concerned with the implications of the design for smaller and medium-size providers of commercial (or, more precisely, TRIA-covered) property/casualty insurance coverage. Two key program features have particular significance for these insurers – the size of the individual insurer deductible and the program trigger.

Higher Deductibles Hurt Smaller and Medium-Size Insurers. Under TRIA, every insurer writing covered lines of business faces an individual company deductible based on the premiums earned for those lines of business. There are policy reasons for this design, but an implication is that the deductible any insurer will absorb after a terrorist attack is not tied to the insurer's capital position.² This also means that many small to medium-size insurers currently writing TRIA-covered lines of business may have a significant share of their capital at risk in the event of a terrorist attack.

Individual insurer deductibles have increased significantly since the program's inception in 2002.³ Kunreuther and Michel-Kerjan have provided helpful research into the effects on much of the industry of the increases in deductibles.⁴ Examining the Kunreuther and Michel-Kerjan approach from a somewhat different perspective illustrates the potential impact of rising deductibles on smaller and medium-size insurers and on their

²Indeed, there have been those in the industry who have argued that the TRIA deductibles should be a percentage of surplus (capital), rather than premiums.

³The individual insurer deductibles under TRIA and TRIEA (the 2005 extension) have been as follows: 7.0%-2003, 10%-2004, 15%-2005, 17.5%-2006, 20%-2007.

⁴"Looking Beyond TRIA: A Clinical Examination of Potential Terrorism Loss Sharing", in *"Seeds of Disaster, Roots of Response How Private Action Can Reduce Public Vulnerability"*, 2006, edited by Auerswald, Branscomb, LaPorte, and Michel-Kerjan.

presence and role in the industry's competitive balance.

For this analysis we have used a database composed of the entire property/casualty industry writing TRIA-covered lines of business. The database includes 1,027 insurer groups or individual insurers reporting at least \$500 of earned premiums in TRIA-covered lines of insurance in 2005, the latest year for which complete data are available. In the analysis, we have calculated each insurer's TRIA deductible⁵ and compared it to that insurer's reported policyholder surplus, or capital. The analysis takes account of the deductibles of insurer groups, where the companies in the groups file a consolidated Annual Statement, but treats as individual companies those that do not file consolidated Annual Statements. In practice, TRIA's implementing regulations would bring more of these insurers together for purposes of determining deductibles.

The distribution of insurers by their TRIA deductible to policyholder surplus ratios (D/S ratio), using the 2006 deductible level (17.5 percent) and 2005 premium and surplus data, indicates 21 percent of insurers writing TRIA-covered lines in 2005 had D/S ratios exceeding 20 percent. That is, in the event of a terrorist attack that triggers the program, these insurers face a deductible potentially greater than 20 percent of their total capital; the overwhelming majority (96 percent) of these companies are medium and smaller insurers. This exposure is increased by the insurer's retention of an additional 15 percent of losses above its deductible (the coinsurance share). There is a high likelihood that this problem will grow worse for insurers in 2007, given that the program deductible has risen to 20 percent of premiums. For those insurers whose surplus has not risen proportionately with both the increase in deductibles and TRIA-premiums increase, the exposure to TRIA deductibles will worsen. Any further net increase in the insurer deductible or the insurer co-payment requirement will worsen this problem and fall most directly on small and medium insurers.

Even with the TRIA program in place in 2007, these insurers will face important questions about how they can manage and reduce their exposure to terrorism risk, as well as likely pressure from regulators, catastrophe modelers, and independent rating agencies. In a 2005 analysis, A.M. Best Company (the leading financial strength rating organization in the industry) has noted that insurers with exposure to losses greater than ten percent of surplus "...could be exposed to rating action."⁶ Recently, A.M. Best has made the imperative to reduce this exposure even more explicit with its use of a detailed Supplemental Rating Questionnaire (SRQ) seeking important details on individual insurers' potential maximum exposure to terrorism risk in eleven cities.⁷ If TRIA is not renewed or if its passage is significantly delayed, this pressure will only intensify.

Higher Program Triggers Hurt Smaller and Medium-Size Insurers. The level of program "trigger" is an even more significant issue for medium and smaller insurers since it determines when the program will be activated; that is, whether it will pay for *any* losses. Insurers face a risk that they may suffer a terrorism loss that will be less than the program trigger, leaving them with no protection from the program. The higher the program trigger, the greater the risk. The trigger was \$5 million from 2002 – 2005, but raised to \$50 million in 2006 and \$100 million in 2007.

One way to understand the effect of increasing the trigger is to look at the number of insurers whose capital is less than the trigger – that is, the number of insurers who could face a loss that does not trigger the program, but which exceeds their total capital. Of the 1,027 insurers writing some TRIA-covered insurance in 2005, three-fourths (75.5 percent) had policyholder surplus less than the \$100 million 2007 program trigger. Though some consider it unlikely that any single insurer will face a terrorism loss of significant size that doesn't also trigger the program, there are highly relevant examples of terrorist attacks that have done most of their damage to a single building and its occupants.⁸

Combining this fact with workers compensation benefits can easily produce losses in excess of acceptable parameters. For example, A.M. Best estimates (in its SRQ) that a typical death benefit paid in Massachusetts is

⁵TRIA deductibles are calculated as follows: Direct Premiums Earned in the immediate prior year in TRIA-covered lines of insurance, multiplied by the TRIA deductible percentage (e.g., 17.5%).

⁶A.M. Best Company, "Terrorism: Too Risky Without TRIA?," Dec. 2005.

⁷The eleven cities identified for analysis by A.M. Best include: New York; Chicago; San Francisco; Washington, D.C.; Boston; Seattle; Los Angeles; Houston; Philadelphia; Las Vegas; and Miami.

⁸The 1995 attack on the Murrah Federal Building in Oklahoma City is a case in point. 168 people died in the attack; 163 in the Murrah Building; five elsewhere.

\$1 million. An attack on a single small employer in Boston that killed 80 employees (less than half the number of those killed in Oklahoma City in 1995) would produce gross losses of \$80 million. If unreinsured, a loss of this level would be devastating to at least 75 percent of the insurers currently writing terrorism risk. Given the lack of significant private reinsurance capacity for terrorism risk, the odds are high that the risk would be unreinsured or only partially reinsured without TRIA. If this is the exposure to be faced by an individual insurer, many will face very difficult questions about their ability to continue participating in these markets.

Small and Medium-Size Insurers Provide Essential Competition and Consumer Choice. TRIA deductible and trigger levels have a disproportionate impact on small and medium-size insurers. The argument that policymakers should not be concerned with a particular market segment (e.g. small and medium-size insurers), but rather only whether an insurance “market” exists, should be rejected. It would be a curious public policy perspective that expressed concern for a “market,” but not for the vast majority of the firms that actually populate that market. Though unregulated markets develop over time in a way that makes some business models obsolete and allows other to thrive, terrorism is fundamentally different from other risks that arise in a market economy and require changes in business models. For all of the reasons insurers have argued that terrorism is different and uninsurable, allowing the structure of a government policy response to make small and medium-size insurers less competitive is inappropriate public policy.

From the perspective of insurance consumers, a program structure that imperils small and medium-size insurers and forces their reconsideration of, or withdrawal from, terrorism insurance markets can only be negative. There is significant market participation by these insurers; for example, small and medium-size companies represent 85 percent of workers compensation writers and 92 percent of other liability writers, accounting for market shares of 27 percent and 18 percent in these lines of business, respectively.

Market shares written by small and medium-size carriers vary across the states; in 33 states these carriers have between 20 and 40 percent of the TRIA-covered lines market share, and in one state (Hawaii) it is more than 40 percent. These market shares represent tremendous competitive “presence”, the abrupt loss of which would severely disrupt markets and rob consumers of valuable choices.

The small and medium-size insurers that write TRIA-covered lines of insurance have an economic impact well beyond the market shares they write. They are significant employers, estimated to provide jobs to some 220,000 people nationwide, with a payroll exceeding \$11.6 billion. The “downstream” annual economic impact of the payroll provided by these insurers is estimated to be over \$17.5 billion.⁹

Small and medium-size insurers are more regional in nature, serving tightly defined consumer market segments. Their loss from these markets would negatively impact consumer choice and consumer service and is not a loss that ought to be created or encouraged by Federal program design.

Conclusion. The enactment of a long-term federal terrorism reinsurance program is essential to the stability and continued growth of the U.S. economy. It is a critical element in efforts to protect the economic security of the country against the threat of terrorist attack and is the responsibility of the federal government.

In designing a future program, a key principle should be that it not interfere with or disrupt the competitive playing field that otherwise exists in the market. In this instance, the provisions of an extended terrorism reinsurance program should not create barriers to the ability of smaller and medium-size insurers to continue serving markets and consumers.

Insurance consumers will have more choices, prices will be lower, and product innovation will be greater when the greatest possible number of strong, viable competitors can serve the market. The design of the federal terrorism reinsurance program must not disrupt that competition.

⁹PCI estimates.