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Issue Brief

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Managing Terrorism Risk Requires Federal Financial Role and Broad Industry Participation[1]

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Introduction

Ordinarily, insurers' ability to provide coverage for insurable risks is enhanced to the extent that government intervention in insurance markets is minimized. For example, when government refrains from using regulation to control prices, restrict underwriting freedom, and mandate coverage, insurers' ability to provide coverage is enhanced. Terrorism risk is not an ordinary case, however, because it fails to meet the basic criteria of insurability. When a risk is uninsurable, government intervention is needed to provide at least partial coverage to augment the private sector's limited capacity to bear the risk. So it is with terrorism risk.

The National Association of Mutual Insurance Companies (NAMIC) has developed a "Statement of Principles on Terrorism Insurance" that outlines the details of a long-term program for insuring against terrorism risk. NAMIC's statement appears at the conclusion of this *Issue Brief*. As approved by the NAMIC Board of Directors, the principles are based on two fundamental points: First, any long-term program for handling terrorism risk must include a permanent financial role for the federal government. Second, the program must be structured so as to encourage broad participation by many individual insurers, including small- and medium-sized companies.

Discussion

I. Because terrorism risk remains inherently uninsurable, any long-term solution must include a substantial financial commitment from the federal government.

Compelling explanations of why terrorism risk is uninsurable by the private market alone have been provided elsewhere, so there is no need to rehearse them here. Yet some policymakers have avowed that the government's financial role in supplementing the private terrorism insurance market must end when the Terrorism Risk Insurance Extension Act (TRIEA) expires in two years, thus shifting the burden of insuring against terrorism risk entirely to the private sector. While insurers and reinsurers have powerful economic incentives to maximize the role of the private sector, there is only so much they can do when faced with a risk that fails to meet basic criteria of insurability.

Nevertheless, opponents of a continuing government role insist that "the market" is fully capable of creating mechanisms that will provide an adequate supply of affordable terrorism insurance. Government intervention in the form of a reinsurance backstop, they say, merely serves to inhibit the creation of market-driven solutions. At the same time, critics have chided the insurance industry for failing to devise a comprehensive plan to generate greater terrorism insurance capacity during the three-year life span of the original TRIA program.

But the critics cannot have it both ways. If private markets alone were capable of providing terrorism insurance, it would not be necessary to cajole profit-seeking businesses into increasing their participation in these markets. Markets behave spontaneously according to the needs and desires of self-interested actors. They are not amenable to deliberate, coordinated planning of "long-term solutions" to public problems. To the contrary, planning is what governments do when individual sellers of goods and services have no economic incentive to provide what buyers want. Such is the case with terrorism risk. The fact that policymakers have instructed insurers to develop "[l]ong-term solutions to enhance insurers' financial wherewithal to address terrorism-related issues" (to quote from the discussion questions distributed by the NAIC in preparation for today's meeting) is proof that market forces alone are inadequate to the task at hand.

Some have argued that the private market would already have produced the desired results had private reinsurers not been "crowded out" of the terrorism insurance market by the government reinsurance backstop established under TRIA. This notion has been directly challenged by representatives of the private reinsurance industry, who would seem to be in the best position to judge whether TRIA was depriving reinsurers of lucrative business opportunities. Even if TRIA had usurped the role that would otherwise have been played by private reinsurers, the fact that TRIA had a fixed expiration date should have served as an incentive for commercial reinsurers and purveyors of other types risk-transfer instruments to enter the market as soon as the federal government withdrew. The fact that they showed no interest in doing so suggests that they lacked sufficient capacity to offer terrorism reinsurance, or simply regarded it as an unattractive line of business.

In other words, the failure of reinsurers to aggressively compete for opportunities to write terrorism reinsurance coverage as TRIA was nearing its expiration date was a market-driven decision. After all, if the federal government announced that in three years it would withdraw from the market for postal delivery service, it is reasonably certain that dozens of private firms would immediately signal their eagerness to capture the government's share of this market. Conversely, if the government announced that in three years it would abandon the market for passenger rail service, it is doubtful that any private railroads would be interested in supplanting Amtrak.

In 2002, Treasury Secretary Paul O'Neill predicted that by the time TRIA expired, terrorism risk would be "less uncertain," thus leading to the development of a thriving private terrorism insurance market. At the time, some insurers shared that view. Unfortunately, we are no better able to predict the frequency and severity of future terrorism-related losses today than we were in 2002, which is why terrorism risk remains uninsurable. As long as this is the case—and there is no reason to think the situation will change any time soon—a TRIA-like government reinsurance layer or backstop must be part of any workable long-term solution.

II. To avoid overexposure to terrorism risk, a long-term solution must be designed to ensure that the risk is spread among many individual insurers, including small- and medium-sized companies.

The way to responsibly maximize private sector capacity for insuring against terrorism risk is to draw as many individual insurers as possible into the terrorism insurance market. To that end, the government reinsurance program should feature insurer deductibles and an event trigger set at levels that would not adversely affect small- and medium-sized insurers. Policymakers must be sensitive to the fact that the threat of insolvency—or a rating agency downgrade—would inexorably force these insurers from the terrorism insurance market. And because there are limits to the amount of loss exposure that even very large insurers can absorb, no one should assume that large carriers would fill the void created by the smaller companies' exit.

That is because in addition to being a man-made risk that is deliberately unpredictable, terrorist attacks are intended to produce large-scale catastrophes for which losses tend to be correlated. The terrorist's objective is to inflict damage that results in thousands of concurrent losses whose aggregate cost reaches staggering sums. If too much of this risk is borne by too few insurers, a single event could drive a company to insolvency, leaving it unable to pay claims. For this reason, insurers prudently attempt to avoid overexposure to extreme events such as terrorism, earthquakes, and hurricanes. It is not surprising, for example, that in the aftermath of Hurricanes Katrina, Rita, and Wilma, some large companies have begun shedding portions of their share of the homeowners insurance market in catastrophe-prone areas—even though doing so will reduce their premium income.

Because the frequency and severity of terrorist attacks is less predictable than natural disasters, the need to avoid overexposure to this extraordinarily capricious risk is especially great. Establishing the conditions under which many different insurers are capable of bearing a portion of terrorism risk should be a central goal of any program to ensure the long-term availability and affordability of terrorism insurance.

NAMIC Statement of Principles on Terrorism Insurance[2]

- Terrorism is an ongoing threat to the people and government of the United States. Therefore, a long-term insurance industry program coupled with a government backstop at an appropriate level of loss is essential to assuring an orderly economic recovery and reconstruction effort after any significant terrorist attack.

- The Terrorism Risk Insurance Extension Act of 2005 is a stop-gap measure that must be converted into a long-term, private/public-sector program.

- The government backstop was established under TRIA because there is currently insufficient private-sector terrorism insurance and reinsurance coverage to provide adequate coverage in the event of another large-scale terrorist attack.

- A long-term, private/public terrorism insurance program is necessary because terrorism is fundamentally an uninsurable risk due to the inability of insurers to predict when events will occur and because of the potentially catastrophic costs of an attack.

- To be effective, a permanent terrorism program must allocate the costs of terrorism events between the private and public-sector in a way that maximizes private sector involvement while assuring that private insurers can continue to meet their obligations across all economic sectors and insurance product lines after a terrorism event.

- The goal of public policymakers should be to allow the private sector to take on as much of the risk as possible by devising a plan that will enable insurers and reinsurers to provide coverage at affordable prices so that businesses and commercial property owners will purchase it.

- We recommend adoption of a three-tier solution.

    1. The first layer would consist of private primary insurance and reinsurance as exists under TRIA, and would include the following elements:

        - A permanent event trigger of no more than $50 million to encourage more participation by small- and medium-sized companies. A higher trigger would drive smaller and medium-sized companies from the market because reinsurance costs would be too high making primary coverage unaffordable.

- Individual company deductibles and the industry retention level tied to premium income, but set at levels that would enable the industry to continue to meet its financial obligations and perform its economic role after paying off its share of the losses from a terrorist attack.

- Preemption of state laws that prohibit insurers from excluding terrorism and preventing the free market from setting adequate rates for terrorism insurance. The preemption can be tied to a federal requirement that all companies over a certain size must offer terrorism coverage to commercial policyholders.

2. The second layer would be an industry-sponsored reinsurance facility to encourage the development of new private-sector capital for terrorism. It would act as a bridge between the purely private sector layer and the public/private-sector liquidity backstop in the third layer.

    - Initially it should cover losses of about $10 billion to see just how much private-sector capacity can be developed.

    - U.S. companies eligible to access recoveries from the fund would fund the initial and ongoing capitalization through a policyholder surcharge.

    - The facility should be authorized to purchase reinsurance protection financed through the market for risk linked securities (RLS).

3. The third layer would be a public-private partnership that would provide liquidity support for the financial markets in the wake of catastrophic terrorist events.

    - It would be funded in part by a fixed annual policyholder surcharge.

    - Aggregate annual financial protection would be provided for 90 percent of all eligible losses, losses beyond those covered by the first two tiers, up to $100 billion.

- Terrorist attacks involving nuclear, biological, chemical and radiological weapons should be excluded from the program, as should fires following a terrorist attack. The costs of such events would overwhelm insurers, preventing them from fulfilling their financial obligations to policyholders in other lines of insurance, thereby exacerbating the impact on the economy.

- By encouraging the maximum private-sector protection while recognizing the need for federal back stop, a successful TRIA program will reduce government exposure, increase the take-up rate for terrorism coverage among businesses and commercial property owners, and thus reduce the costs the federal government would otherwise bear in the event of a catastrophic terrorist attack.

Endnotes

[1]Delivered at a meeting of the NAIC Terrorism Insurance Implementation (C) Working Group, March, 29, 2006.

[2]Approved by the NAMIC Board of Directors, March 16, 2006.