TRIA Update

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The US Treasury Report on TRIA

As we were drafting our analysis of the US Treasury's recent report on the Terrorism Risk Insurance Act (TRIA), the bombings in London brought a terrible reminder that terrorism strikes with no warning and knows no geographical boundaries. Alongside our personal response to these atrocities, we try as always to assess the impact on insurance coverage. We note that Spain, target of a similar public transit terror strike in March 2004, as well as the UK, have long-running government terrorism insurance programs. This may be due to the unfortunate fact that they have lived with terrorism longer than we have in the US – the UK has the Irish Republican Army, and Spain its Basque separatists. One wonders how the debate on TRIA might change should the US suffer another terrorist attack. The London atrocities certainly have had an impact – even more impassioned pleas from the US insurance industry to maintain TRIA. This sentiment echoes a report from the Organisation for Economic Co-Operation and Development published two days before the London bombings that warns of continuing shortfalls in Terrorism insurance cover.

While Treasury Secretery John W. Snow may have backpedaled a bit during his July 13 testimony in front of the House Committee on Financial Services, the TRIA report, issued a week before the London attacks, still stands. The report delivers a fairly clear message to the insurance industry: it's time to fly on your own. The report finds that, based on an analysis of marketplace activity over the past two years, insurers are ready and able to assume the risk of Terrorism, and, in fact, the presence of TRIA inhibits the development of private capacity for this risk. The demise of TRIA would likely cause something of an upheaval, but it would be short-lived, and the markets would quickly stabilize.

Whether or not insurers or insurance buyers agree with these findings, the report will generate anxiety for some policyholders about how this important coverage will be handled after December 31, 2005. For now, what can be done? Some suggestions, following an analysis of the report, appear below.

The Long-Awaited Findings

Responding to a requirement of TRIA, Treasury issued its long-awaited report to Congress with the goal of assessing:

- The effectiveness of the Act in 1) making Terrorism insurance readily available to policyholders at acceptable prices and 2) allowing the private markets to stabilize and re-build Terrorism capacity following 9/11
- The probable capacity of the commercial Property and Casualty market to provide Terrorism coverage absent TRIA
- The availability and affordability of Terrorism insurance to certain industry sectors, most notably railroads, trucking and public transportation

To assist with this evaluation, Treasury enlisted a third party to develop, administer and help analyze a series of surveys sent to both policyholders and insurers during the last two years. The report contains numerous graphs and charts setting forth the findings of the surveys, which this bulletin will synthesize. Full copies of the report can be found on www.treasury.gov.

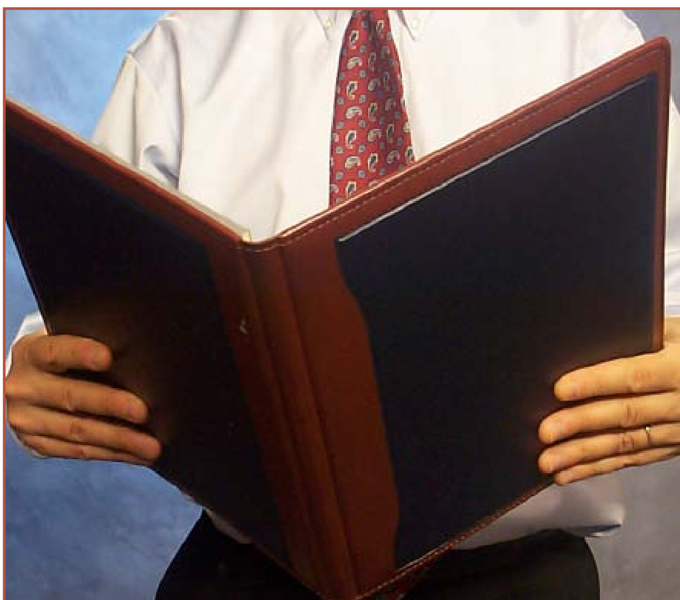
The coming weeks may be decisive in determining TRIA's fate. We will issue new *TRIA Updates* as often as required to keep you informed of the progress of this important and rapidly evolving public debate.

Effectiveness of TRIA

Despite the steady increase in insurer deductibles to the current 15 percent of 2004 direct earned premium, both the take-up rate among policyholders and the number of insurers willing to provide Terrorism coverage have risen "somewhat" under TRIA, a trend Treasury interprets as "a pattern suggestive of a market increasingly able to provide coverage." Moreover, pricing for this risk in some ways became more consistent in 2004, with policyholder and insurer surveys showing a range of 1.7-1.8 percent of premium, slightly higher (1.9 percent) for those in high-risk cities[1].

As for the commercial Property & Casualty market's stabilizing with TRIA, Treasury reports that industry surplus "has returned to pre-9/11 levels…[and the industry is] financially stronger and able to bear unexpected losses." In a perhaps unconscious acknowledgement that this may, in fact, be due to a lack of recurrence of Terrorism events in the US, Treasury notes that "insurer financial strength would have improved whether or not TRIA was enacted."

Treasury's report finds that TRIA was effective but this effectiveness should not translate into an extension or renewal of the program. Rather, it concludes that "the sunset of TRIA should encourage the development of the private reinsurance market and other risk transfer mechanisms." In its report, Treasury notes that while it did undertake a survey of reinsurers, the results were inconclusive, perhaps because TRIA neither required their participation nor provided TRIA should reinsurers have chosen on their own to provide support to primary insurers.



The Capacity of Insurers in the Absence of TRIA

Treasury acknowledges that TRIA's expiration will likely lead to a "short-lived adjustment in coverage and pricing." In other words, capacity will come down, pricing will go up and policyholder take-up rates will decrease. In the longer term, however, Treasury concludes that the market will stabilize for the following reasons:

- Through refinements in catastrophe modeling, it has become easier for insurers (and therefore reinsurers) to assess the severity of certain risk scenarios. "Challenges do remain," however, for judging the probability of Terrorism events.

- Measured in terms of third-quarter figures year over year, policyholders' surplus was higher in 2004 than in any of the three preceding years. Treasury notes that policyholders' surplus is one of the measures insurers use to assess how much otherwise unprotected capital they can have at risk.

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Treasury hedges its optimism by noting that surplus is not the only factor that might influence insurers. They may also consider "factors such as the possibility of insolvency…and the effect on credit ratings." Either of these could lead to the following measures being taken:

- Greater use of reinsurance (in surveys, large insurers showed less of a tendency than smaller insurers to purchase reinsurance for Terrorism – and none of these insurers, apparently, cited the availability of coverage as the reason)
- Raising surplus through capital market offerings
- Increasing Terrorism premiums
- Decreasing or excluding Terrorism coverage

In this last regard, Treasury acknowledges the effect that state regulations have on insurers' options, whether in terms of disallowance of exclusions and limitations or of the requirement to cover fire following a Terrorism event. Nowhere are the effects of regulations evidenced more starkly than in Workers' Compensation, where even nuclear, biological or chemical injuries must be covered.

In the end, Treasury's position is that TRIA "crowds out development of some reinsurance markets, and delays the development of private capacity."

[1] Per Homeland Security: Chicago, Houston, Los Angeles, New York, San Francisco, Seattle and Washington, DC

Availability of Terrorism Insurance for Certain Occupancies

TRIA required that Treasury's assessment would examine the availability of and pricing for Terrorism for several sectors considered the backbone of commerce: railroads, trucking and public transport. The surveys showed that take-up rates from 2002 to 2004 increased from 25 percent to 32 percent for railroads, from 23 percent to 43 percent for trucking and from two percent to 36 percent for public transport, leading to the conclusion that availability of Terrorism coverage increased. Regarding pricing, the report was less conclusive, as less data were gathered. For example, barely more than a dozen railroads out of a group of 421 answered questions regarding pricing.

Secretary Snow's Covering Letter

Perhaps as important as the report itself – whose many "factoids" can be viewed from varying perspectives – is John Snow's covering letter which is clearly a shot across the bow of Congress and reflective of the Administration's position on extending or renewing a government backstop. Below are some excerpts from that letter.

"…[T]he economy is more robust today than when TRIA was enacted. GDP growth is up from 2.3 percent in 2002 to 3.9 percent in 2004 (fourth quarter over fourth quarter). Unemployment, which reached 6.0 percent in December 2002, is down to 5.1 percent in May 2005. Construction jobs, taking residential and nonresidential together, now stand at a record high 7.2 million. Extending TRIA would have little impact on the economy given its current strength."

Some attention is given in the report to the vitality of the residential building market (now 16 percent of GDP and described by some as overheated or a bubble) and the comparative lethargy in commercial construction. The need for adequate protection for the latter was often cited by those supporting a TRIA proposition and its failure to prosper with TRIA may now be used by the Act's opponents as an example of the Act's having failed.

"It is our view that continuation of the program in its current form is likely to hinder the further development of the insurance market by crowding out innovation and capacity building…. [T]he Administration opposes extension of TRIA ***in its current form****."* [emphasis ours]

No surprise here. It is unlikely anyone believed that this legislation would be "renewed as expiring," to use insurance parlance. "Free reinsurance from the government at taxpayers' expense," no wooing of reinsurer participation, purported disincentives for policyholder risk mitigation, etc. argue against simple renewal. The challenge over the very short period that remains in the Congressional session is: how can and must the private (re/insurers, capital markets and policyholders) and public sectors be brought together for a long-term resolution of a now recognized long-term threat that was not recognized as such when TRIA was originally enacted?

"…The Administration would accept an extension only if it includes a significant increase to $500 million of the event size that triggers coverage, increases the dollar deductibles and percentage co-payments, and eliminates from the program certain lines of insurance, such as Commercial Auto, General Liability, and other smaller lines, that are far less subject to aggregation risks and should be left to the private market."

Again, nothing surprising. An increase in the event size seems reasonable, even if the quantum of the increase does not. Remember that before the enactment of TRIA, ISO-promulgated Terrorism exclusions established $25 million as the threshold below which no event could be categorized as Terrorism and coverage denied. It is extremely hard to envision an event costing as little as $5 million, the current threshold, warranting the investigation and declaration of an event for TRIA purposes.

Certainly from an industry perspective, a $500 million event is completely manageable. More problematic would be an event involving only a small number of insurers or, worst case, only one insurer with a high deductible (some insurers are reported to have deductibles in the billions of dollars) and no other Terrorism reinsurance available.

The report speaks to the inequities of insurer deductibles under the law as it is currently written. It compares the deductible of a large multiline carrier in a monoline event against that of a smaller monoline carrier affected by the same event, drawing the conclusion that in the case of the former such an event might be entirely within its deductible. Caveat emptor to captives writing TRIA coverage only: the report is fairly specific that the government's backstop might not respond to losses such captives sustain.

The issue of excluding Auto and General Liability, which Treasury deems immune from the aggregation potential of Workers' Compensation and Property, raises several points. The report notes that of the total 2003 premiums attributable to TRIA-eligible lines (approximately $209 billion), 25 percent was attributable to each of the following: Workers' Compensation, Other Liability and Property. Taking Other Liability out of the mix while simultaneously lifting the TRIA event threshold and increasing both insurer deductibles and coinsurance would clearly lead to a sharp increase in the percentage of direct earned premiums used to calculate insurers' deductibles.

"It is also important to keep in mind that the program would cover damages awarded in litigation against policyholders following a terrorist attack. Current litigation rules would allow unscrupulous trial lawyers to profit from a terrorist attack and would expose the American taxpayer to excessive and inappropriate costs. The Administration supports reasonable reforms to ensure that injured plaintiffs can recover against negligent defendants, but that no person is able to exploit the litigation system."

The tort reform card – dealt once again. This issue held up enactment of TRIA in 2002 and Treasury's suggestion that both Auto and General Liability be exempted from any future program seems to present TRIA's supporters with a challenge: either tackle the issue of tort reform or do not expect to leave taxpayers on the hook for excessive legal expenses and awards arising from a Terrorism event.

Early Congressional Reaction

In a not altogether surprising split along party lines, Republicans roundly applauded Treasury's report and the guidance the White House has given on restrictions it would seek were TRIA to be renewed or extended. Democrats, on the other hand, were less sanguine. In a concession to those calling for a prompt determination of TRIA's fate, Senator Richard Shelby (R–AL) signaled he will have that body take the matter up in its August session. He also acknowledged that TRIA, which he voted against in 2002, was so flawed that some sort of extension was almost a *fait accompli*. But the devil is in the details.

Carrier Reactions to Proposed Excluded Lines

D&O carriers are aware that should TRIA be allowed to expire, they may face exposures in connection with policies that carry beyond the December 31 expiration date. For now, they appear to be taking a wait-and-see approach, with an increased emphasis on contingency planning that reflects the Sarbanes-Oxley Section 404 requirements, to properly assess and disclose risks facing them. For companies in certain industry sectors – infrastructure sectors such as energy, financial institutions and healthcare – carriers are looking to manage their aggregate limits – their exposures across all lines.

With regard to the proposed exclusion of Other Liability, we have received some interesting initial feedback from the relevant markets. However, they emphasize that this will be a constantly evolving equation and, thus, comments below are the "views of the day subject to change." Markets believe any such exclusion creates the following problems:

- First, the situation is more severe for Excess Liability than for Primary Liability.
- Similar to Workers' Compensation and Property, high-profile locations will be subject to greater underwriting scrutiny and possible declinations and/or significantly higher rates. This applies to the classes you would expect, including: property management, property owners, trucking and truck/auto leasing, municipalities, railroads and chemical/energy.
- As with other lines of coverage, certain states, namely Florida, Georgia and New York, have refused to allow Terrorism exclusions on either an admitted or non-admitted basis. The current thinking is that in these states insurers will be forced either to insure a risk including full Terrorism or to decline it entirely. In the case of the former, committed capacity could be restricted as lines for other perils are forced to mirror lines for Terrorism.
- Finally, underwriters have also suggested that they will need to re-file their rating plans with states to account for the exposures in a post-TRIA environment. As noted above, this inherently suggests we could see significantly increased rates for some industries, and/or perhaps more transactions written on a non-admitted basis.

The Reinsurance Market – a Viable Substitute for TRIA?

There are constraints on reinsurers' abilities to absorb significantly increased Terrorism risk in a post-TRIA environment. Expiration of TRIA would lead to an increased demand for Terrorism reinsurance, but not a significant increase in supply. The expiration of TRIA would not, we believe, stimulate much additional capacity, and certainly would not engender more than

$4-6 billion of Terrorism reinsurance capacity, much less than the $100 billion backstop provided by TRIA. The constraints on reinsurance capacity for Terrorism are self-evident to anyone who analyzes the availability issue from a reinsurer perspective.

Publicly Traded Reinsurers Manage Risk Accumulations

With more of the reinsurance capacity coming from publicly traded reinsurers, and with investors and stock analysts demanding far greater transparency, reinsurers are closely managing their peak accumulations for loss in any one event, whether from a natural catastrophe or from a terrorist act. This creates a constraint on the total amount of private sector Terrorism capacity.

Managing to an "Amount Willing to Lose"

Reinsurers (as do insurers) manage their "amount willing to lose" in any one event. While risk appetite varies from company to company, it would be uncommon for a reinsurer to knowingly underwrite Terrorism risks that would expose greater than 10 percent of its policyholders' surplus. Given the potential for multiple acts of Terrorism, reinsurers may manage to a lower percentage of loss in any one event. With the US reinsurance market capitalized at about $50 billion as of December 31, 2004, managing to a 10 percent "amount willing to lose" would generate $5 billion of Terrorism capacity. If you add in capacity from all other reinsurers worldwide and optimistically double the worldwide Terrorism reinsurance capacity to $10 billion – that is still a drop in the bucket compared to TRIA's providing a $100 billion backstop.

Terrorism Modeling – Still Unproven

Unlike Catastrophe modeling for wind or earthquake perils, Terrorism models are still very new, and insurers and reinsurers cannot rely as heavily on them as they do on models for Natural Catastrophe perils. The probability assumptions embedded in the Terrorism models are unproven and thus do not have sufficient credibility yet. Even the Treasury Department in its report acknowledges, "In order to effectively model the probability of a terrorist attack – including identifying targets, estimating frequency of attacks and forecasting attack size – modelers may need to be able to understand terrorists' motivations, goals and resources. In addition, modelers may need to understand terrorists' adaptive reactions – changes in their methods and approaches, in response to improved deterrence." Unlike Natural Perils Catastrophe modeling, Terrorism modeling clearly does not provide reinsurers with the confidence required to commit more capacity.

> Reinsurers need to be conservative regarding Terrorism, because following a large terrorist attack it is possible, if not likely, that the stock and bond markets would drop sharply, thereby causing a drop in reinsurers' capital bases.

Quantifying Potential Reinsurance Capacity

If, on the most optimistic basis for the perils that reinsurers are most comfortable reinsuring; i.e., property Natural Catastrophe, the maximum worldwide reinsurance capacity is no more than $25-30 billion, surely the worldwide capacity for Terrorism reinsurance will be a subset of this amount. When considering the potential reinsurance market capacity for Terrorism, there are several further constraints in addition to the uncertainties of modeling and investor concerns mentioned above:

- Accumulation of Exposure From Multiple Lines of Business
  Reinsurers need to build in other exposures such as Workers' Compensation, Life, Accident and Health, and thus they would not offer nearly as much capacity for property Terrorism as they would for property Natural Catastrophe capacity.

- Absence of Retrocessional Protection
  Unlike property Natural Catastrophe reinsurance, Terrorism reinsurances would have little or no retrocessional protection; hence, whatever capacity reinsurers offer for Terrorism is retained largely, if not completely, net against their capital base, which limits their risk appetite.

- "Risk of Ruin" Posed by Nuclear, Biological and Chemical (NBC) Attacks
  The use of nuclear, chemical or biological weapons could dramatically increase the scope of the areas impacted by a terrorist attack, rendering wholly inadequate even the most conservative assessments of loss potential from such an event. The potential "risk of ruin" to a reinsurer – especially those that are publicly traded – has prompted them to significantly curtail their capacity for Terrorism unless NBC attacks are sub-limited or excluded outright. Reinsurance

capacity for Terrorism including NBC protection is less than three percent of the TRIA capacity (i.e., $3 billion maximum versus $100 billion under TRIA).

- Stock Market Factor
  Reinsurers need to be conservative regarding Terrorism, because following a large terrorist attack, it is possible, if not likely, that the stock and bond markets would drop sharply, thereby causing a drop in reinsurers' capital bases. So, precisely at the time when reinsurers are asked to pay out, they would potentially face a sharp drop in their assets. This acts as a further constraint on reinsurers' willingness to "push out the boat," to authorize far greater capacity for Terrorism reinsurance and as a factor acknowledged in the Treasury report as affecting both insurers and reinsurers.

Reinsurers and Brokers Not Consulted

It is interesting to note that the Treasury Department in its survey did not effectively include reinsurers or poll brokers at all, sidelining two sources of information that would have provided material comments regarding the viability of the reinsurance marketplace taking on substantially more Terrorism exposure in the absence of TRIA. Reinsurers would have commented on the financial and investor-oriented constraints limiting private sector Terrorism capacity. Brokers would have helped to interpret current reinsurance marketplace dynamics. As with any survey, the interpretation of the facts and figures can lead to a broad range of conclusions.

One example is very illuminating. On page 120, Treasury's report infers that the reinsurance market's willingness to provide coverage for non-certified Terrorism (i.e., domestic terrorist acts – Timothy McVeigh) "may provide an insight into the development of a Terrorism risk insurance market outside of TRIA." This inference is based on the fact that because reinsurers cover non-certified Terrorism, it is plausible, if not likely, that they will agree to cover certified Terrorism if TRIA expires. Anyone familiar with placing or underwriting reinsurance knows that reinsurers differentiate their capacity for non-certified Terrorism, since they view that peril as a second cousin of vandalism and malicious mischief, civil commotion and riot – which are already covered perils in reinsurance contracts. This inference is a stretch, to say the least, and simply validates the absence of real-time market input from practitioners and capacity providers whose knowledge is real, not theoretical.

Capital Markets – Another Capacity Source?

There is little evidence to suggest that capital markets will respond any more positively than insurers or reinsurers in terms of filling the void that TRIA would create if non-renewed. While there will always be opportunistic commitments of capacity when the ROE is right, whether in insurance, reinsurance or capital markets, the latter is as dependent on modeling as the former two – in fact, because these "insurance" risks are relatively new to capital markets, they are even more dependent on modeling. Moreover, capital markets normally look to commit their investors' assets to uncorrelated risks; i.e., those not likely to generate a negative effect when other investments suffer. Evidence to date suggests the risk is indeed correlated to other financial asset performances.

Policyholder Options Now

We should remember that many insurers have attached "pop-up exclusions" (sunset provisions) to policies running through December 31, 2005 and these take effect even if TRIA is renewed but any changes to it are detrimental to insurers, which almost certainly they will be. This leaves policyholders with the unenviable choice of riding out the wait for Congressional action and hoping for the best, or doing some hedging now.

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Are You Prepared for a Non-Renewal of TRIA?

Some steps you can take now:

- Carefully monitor renewals for sunset provisions and try to secure them with Terrorism coverage embedded without these provisions. If this option is not available or competitive, seek out pricing for stand-alone capacity to fill in gaps (products are available through the Willis Terrorism Practice).

- Consider a cancel-rewrite of existing programs to secure full coverage now, rather than waiting until year-end. This is particularly significant with respect to Property and Casualty programs with:
  - Year-end renewal dates
  - Exposures in high-risk cities
  - Significant aggregate limits

- Consider the purchase of Terrorism options, which charge a pro-rated premium, effective with the year-end expiration of TRIA, cancelable in the event that TRIA is renewed, with 25 percent to 50 percent minimum earned, depending upon the market and the location of the risk.

The stand-alone Terrorism markets in the US, Bermuda and London still have significant capacity in most regions of the US, with total capacity of over $1 billion. However, aggregations are mounting in New York and we may soon see the end of any semblance of competitive pricing.

Programs are available for:

- Terrorism Property – Physical damage and time element including contingencies
  - Evacuation and extra expense costs
  - Biological and chemical attack clean-up – $25+ million available
- Terrorism Liability – Damages and claims expenses, including defense costs
- Terrorism Accidental, Death and Dismemberment

Has the Last Word Been Spoken?

Is Terrorism in the US only a high-risk city threat? Or is a comparable threat faced by those who operate in potentially vulnerable sectors (as well as those located near them and those dependent on them)?

- Utilities (power, water, telecommunications, etc.) generation, transmission and distribution
- Chemical plants
- Oil and gas exploration, refining, etc.
- Railroads and other means of transport (passenger and cargo)
- Ports (marine and air)

One of the disappointments in Treasury's report is the acknowledgement of how few policyholders responded to the surveys – how few of your voices were heard. The Treasury report, however, is not the final chapter on TRIA. There is time for your company's voice to be heard.

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