TRIA Update

Willis

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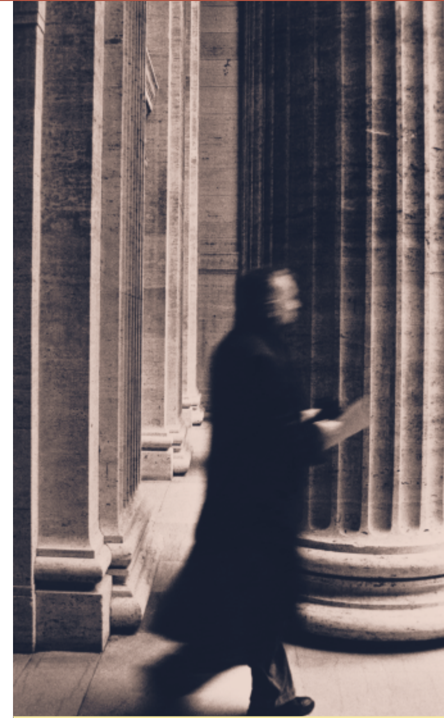
CBO on TRIA: The Congressional Budget Office Paper on Federal Terrorism Reinsurance



To renew, or not to renew. For anyone interested in terrorism insurance, that is the question. Despite the recent introduction of a Senate bill to extend TRIA for two years, the answer to whether or not the federal government will renew the Terrorism Risk Insurance Act (TRIA) beyond its December 31, 2005 expiration may not arrive before mid-year. In the meantime, a recent government analysis conveys some of the mixed feelings in Congress regarding TRIA.

The government report emphasizes the value of letting free market forces fill the void that would be left by TRIA's expiration; however, it also acknowledges the uncertainty that expiration would mean for the availability and price of coverage. In this issue of our periodic newsletter on TRIA, we provide highlights of the report and recommendations for risk managers facing terrorism-related exposures.

Update from the CBO

At the request of the Senate Budgetary Committee, the Congressional Budget Office (CBO) prepared a paper, "Federal Terrorism Reinsurance: An Update, January 2005," that "analyzes the TRIA program and assesses changes in the insurance market since the law's enactment in November 2002." (The reader is encouraged to review the report in its entirety at www.cbo.gov.) The CBO emphasizes that its mandate is to provide objective analysis, not make recommendations. It leaves that to the Department of the Treasury's report to Congress, due by June 2005. Nevertheless, the paper's contents are likely to stimulate much discussion.

The CBO's analysis was made in light of TRIA's original aims: "to limit insurance companies' risks of financial loss from terrorism and to increase the availability of terrorism coverage for property owners." The latter specifically addresses Workers' Compensation insurance.

Report Highlights

A free ride? There is no reinsurance premium attached to the government backstop, which means that rates being charged by insurers for terrorism coverage backed by TRIA are below market rates – they are lower than what insurers would have to charge to pass back costs of traditional reinsurance, were it available – which even Federal Reserve Chairman Alan Greenspan has confirmed is not the case. These below-market rates have led to an increase in the number of policyholders buying certified terrorism coverage (and, more recently, coverage for all domestic terrorism events), particularly in high-risk areas.

A disincentive? As a result of this favorable rating structure, TRIA may have served as a disincentive to policyholders to mitigate their terrorism loss potentials. This is an important issue given conventional wisdom that the threat of terrorism in the US can no longer be viewed as a short-term phenomenon. Instead, "a persistent high-level risk of terrorism implies that the owners of assets [and custodians of employees] at risk should adopt measures to reduce their risks – for example, by relocating some activities, retrofitting existing structures, investing in disaster-recovery information systems, and installing security systems." According to the report, there is little evidence

that these measures are being undertaken by the broad base of policyholders and Homeland Security officials are reported to be particularly concerned about the chemical, transportation, banking, energy and utility sectors in this regard.

This disincentive might be eliminated if (1) TRIA were allowed to expire, forcing market rates for terrorism to prevail, or (2) an "actuarially fair premium" could be developed for the government reinsurance. Policyholders would then have the choice of either paying potentially higher rates or protecting themselves "by diversifying their holdings [spreading their employees] among different properties and locations." The argument is made that encouraging greater care on the part of property owners could actually reduce the potential cost to the nation of future terrorism attacks.

Shifting costs. If TRIA is allowed to expire, the actual costs of terrorism risk to the nation may not change, but these costs would be shifted from the taxpayers to the owners of the assets (caretakers of employees) or their insurers, if any.

Uncertainty...and cost increases. If TRIA is allowed to expire, the availability and price of terrorism coverage is uncertain. The report suggests that reinsurers "would most likely continue their previous practice of not covering losses from nuclear, biological, chemical, and radiological attacks." Since these must be covered by Workers' Compensation policies, "rates for [such policies] could rise substantially, at least in the near term" (or availability might be constricted).

Retentions and coinsurance levels: too low? The renewed financial health that insurers have enjoyed for the last two years raises the question of whether or not their current retentions (15 percent of 2004 direct earned premiums capped at $15 billion on an industry basis) and coinsurance level (10 percent of losses above the retention) under TRIA are too low. The paper does not take entirely into account catastrophe losses sustained during 2004, including the Atlantic hurricanes, the Pacific typhoons, and, of course, the horrific Indian Ocean tsunami. These losses are expected to exceed those of September 11, 2001, now estimated at $30-35 billion, yet many underwriters will likely show a profit for 2004. So the issue may not be whether or not insurers can sustain more than the current aggregate amount of $15 billion for TRIA in any one year, but can they sustain more than that alongside another string of traditional loss events in a single year.

Complex Issues

Charging an "actuarially fair premium" for the government backstop is a complex issue. This was on the table when TRIA was first being debated, and the reasons for not charging premiums were numerous. Chief among them were:

- The government did not want to sponsor a permanent program, which is what such a premium might insinuate.
- The government was not equipped to be a rate-maker.

The report suggests these two reasons still obtain, although it also states that there are terrorism modeling programs available now that could assist in assessing risk and developing adequate rating structures. The CBO may give more credence to the accuracy of such programs than insurers (and their reinsurers) do.

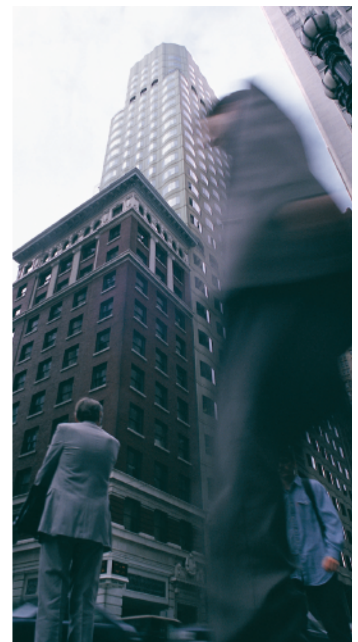
The CBO report acknowledges the influence of state regulations on "insurers' ability to restrict coverage for losses from terrorist attacks and to set risk adjusted rates for some types of insurance." TRIA did not override any state regulations in effect at its enactment; rather, it became the default for policyholders. If a state required more coverage or better terms, those still applied; if the state required less, TRIA prevailed. The report cites specific regulations that remain in effect today in Florida, Georgia and New York, among others, and that are now affecting underwriters' positions on policies that run past TRIA's expiration date. More on this below.

The paper underscores the effect TRIA's expiration may have on Workers' Compensation. It describes an effort undertaken in early 2004 by certain Workers' Compensation underwriters to create a mutual reinsurance pool and the apparent failure of that effort because of concerns about the pool's ability to handle "worst-case scenarios involving biological, chemical, or nuclear contamination." It goes on to say, "uncertainty about the future of the federal terrorism reinsurance program was another factor" in abandoning this effort, so that TRIA's actual expiration might rekindle interest in such a mutual arrangement.

Insurers' Positions on 2005 Property Renewals

As we write in early March, insurers are dealing with TRIA's scheduled expiration in several ways:

- Some are offering a constant level of terrorism coverage for the entire policy term, whether or not TRIA is extended.



- Others are utilizing ISO-based "pop-up" endorsements, meaning that if TRIA is not renewed an absolute terrorism exclusion will apply. These endorsements also stipulate that if TRIA is renewed but the requirement to make the coverage is not, and either 1) their retentions are increased or 2) their co-insurance is increased or 3) the required coverage is broadened (we believe this is aimed at nuclear, biological and chemical contamination), then an absolute exclusion will also apply.

- Still others are providing one terrorism limit until TRIA's scheduled expiration and a lower limit if TRIA is not renewed.

We expect these approaches will be in flux during 2005 as the competitive landscape becomes clearer. We advise insureds to consult their broker on how these insurer positions may affect their renewals.

Some state insurance regulators have not approved the use of "pop-ups" mentioned above nor are they allowing insurers to reduce or sub-limit terrorism liability if TRIA is not renewed. In response, at least one insurer is proposing to either extend its policies in these states to December 31 rather than renew them, or to significantly reduce all-risk capacity renewal. We are concerned about a potential shortfall in available capacity in large metropolitan areas in these states as the year progresses and TRIA's renewal remains in question.

What to Do Now

We strongly recommend that insureds consider purchasing either stand-alone terrorism policies for at least non-certified terrorism (and where appropriate, terrorism outside the US) or newly available options locking in coverage for certified terrorism if TRIA is not extended. In some cases, these programs can be arranged for a multiyear term reaching far beyond December 31, 2005. The earlier such programs can be arranged, the better. While the stand-alone market is robust ($500 million in capacity is now generally available) and competitive today, it may be less so as more uncertainty reigns. Buyers will recall that this market was to a certain extent opportunistic post-9/11 and pre-TRIA. It is likely the market will react similarly if demand starts to exceed supply. Specialized facilities, such as our IPe-Trading facility based in London and Philadelphia, can help tailor a solution for terrorism risks.

Those who are using captives to access the government backstop will also have to determine what their positions will be if TRIA expires. Most such captives are already buying non-certified reinsurance in the stand-alone market, and we offer the same advice to them as above: try to negotiate an option to convert that reinsurance to cover all domestic terrorism if TRIA is not renewed. Some form changes may be required after December

31, but those can be taken care of by endorsement to the captive policy. Willis Captive Management can assist with this transition.

Insurers' Positions on 2005 Casualty Renewals

The Casualty market seems to have gotten off to a slower start in terms of reacting to the potential expiration of TRIA, although we have heard several Workers' Compensation carriers say they will be more assiduous in their modeling of aggregated risks, particularly in metropolitan areas, going forward.

In the meantime, a strong stand-alone market has developed in London and Bermuda for General Liability. This market can provide approximately $200 million in capacity. As with Property, option programs are also now available. Those most interested to date in this capacity are in occupancies with significant public access (OL&T-type) exposures. Again, IPe-Trading can develop the appropriate response to a particular situation.

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