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Terrorism Insurance: The Marketplace After the Terrorism Risk Insurance Act of 2002

Carolyn Cobb, Government and Finance Division

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Abstract. This report summarizes developments since the Terrorism Risk Insurance Act of 2002 was enacted.

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Terrorism Insurance: The Marketplace After the Terrorism Risk Insurance Act of 2002

Baird Webel
Analyst in Economics
Government and Finance Division

Summary

After the September 11, 2001, terrorist attacks on the United States, many businesses were not able to purchase insurance to protect against property losses in any future terrorist attacks. Congress recognized the importance of such insurance for the health of the U.S. economy, and enacted the Terrorism Risk Insurance Act of 2002 (TRIA) to create a temporary "backstop" program to share future insured terrorism losses with property-casualty insurers and with policyholders. The act, P.L. 107-297, required insurers to offer terrorism insurance to their commercial policyholders, preserved state regulation of insurance, and directed the Secretary of the Treasury to administer the program. The marketplace for terrorism insurance has improved since Congress passed the act. It is still unsettled, however, and is likely to remain so until the private market that Congress envisioned can re-establish itself. Of particular current concern have been the "make available" provisions that were set to expire at the end of 2004 before being recently extended by the Treasury through 2005. This report summarizes developments from the date of TRIA's enactment to June 2004. It will not be updated. Please see CRS Report RS21979, *Terrorism Risk Insurance: An Overview*, by Baird Webel for current information.

TRIA Basics

The Terrorism Risk Insurance Act of 2002 (TRIA)[1] created the Terrorism Risk Insurance Program (TRIP), a temporary federal backstop for insurers issuing commercial property-casualty insurance covering risk of losses due to acts of international terrorism. The backstop shares insured losses among insurers, commercial policyholders, and the federal government. Insurers will bear all losses up to $5 billion, insurers and policyholders will share losses from that $5 billion threshold up to $10-15 billion, and the federal government will assume insurance losses above that, up to $100 billion annually. The three-year program sunsets December 31, 2005. Congress intended the temporary

[1] P.L. 107-297, codified as 15 U.S.C. §6701 et seq. For an explanation of the act, see CRS Report RS21444, *The Terrorism Risk Insurance Act of 2002*, by Baird Webel.

backstop to allow the market for terrorism insurance to stabilize and insurers to rebuild their capacity so a private market for terrorism risk insurance would emerge.

TRIA nullified exclusions for terrorism in commercial insurance policies and required insurers to make terrorism insurance available for purchase. This "make available" provision was specified in the act to last until the end of 2004, with an option for the Secretary of the Treasury to extend it until the end of 2005. Insurers must notify policyholders about the cost of terrorism insurance and about the backstop. The notices enable consumers to comparison shop for terrorism insurance and inform them how insured terrorism losses would be shared. TRIA neither set rates nor required policyholders to purchase the coverage. The policyholder has 30 days to accept or reject the proffered coverage. If the policyholder does not purchase coverage, its insurer may reinstate an exclusion for terrorism losses, if permitted by state law.

TRIA expressly preserved state regulation of insurance. It allowed a state to invalidate an excessive or discriminatory rate and to review terms and conditions of the contract for coverage. It delegated implementation and administration of TRIA to the Secretary of the Treasury, however, and directed Treasury to cooperate with the National Association of Insurance Commissioners (NAIC).

Treasury's Regulations

Treasury has issued rules to assist insurers in complying with TRIA,[2] guided by these principles:

- Implement the act in a transparent and effective manner;
- Treat insurers comparably;
- Provide policyholders useful information efficiently;
- Rely on the state insurance regulatory structure;
- Allow insurers to participate in the program in their normal course of business; and
- Support development of a private capacity to provide the coverage.[3]

The first interim final rule, announced in February 2003,[4] focused on clarifying the definitions in TRIA. It defined an act of terrorism as a violent or dangerous act that is committed by foreign interests to influence U.S. policy and that results in damage in the United States. Such an act qualifies under TRIA only if it is certified as an act of terrorism by the Secretary of the Treasury with the concurrence of the Secretary of State and the Attorney General. The Secretary may not certify an act committed in the course of a war formally declared by Congress nor an act causing less than $5 billion in aggregate

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[2] Treasury-released guidance and rules along with other information can be found at [http://www.treasury.gov/trip], visited Jan. 28, 2004.

[3] U.S. Dept. of the Treasury, "Terrorism Risk Insurance Program; Interim Final Rule and Proposed Rule," *Federal Register*, vol. 68, no. 40, Feb. 28, 2003, p. 9805.

[4] Ibid, pp. 9803-9814.

losses for the property-casualty industry.[5] The February interim final rule also determined that:

- Nearly all entities that issue commercial property-casualty insurance — including captives, surplus lines insurers, and state-created entities such as residual funds and workers' compensation funds — must participate in the program;
- In calculating each insurer's deductible, affiliated insurers will be aggregated and treated as a single company under definitions and rebuttable presumptions set out in the rule; and
- Commercial property-casualty insurance will be defined according to current practice of the National Association of Insurance Commissioners.[6]

The second interim final rule[7] was announced in April 2003. This rule clarified how and when insurers should disclose the costs of terrorism insurance to policy holders, as a condition of participating in the program. It generally allowed insurers to use their normal business practices in communicating that information but required them to certify their compliance to Treasury.[8]

Treasury issued final rules incorporating these interim final rules in July 2003[9] and in October 2003[10]. The July final rule further clarified the act's definitions, previously addressed in the February interim final rule. It also expanded on some technical points, including when control of insurer affiliates would be conclusively presumed and when and how it might be rebutted, exactly which amounts to include in calculating an insurer's deductible and any reimbursement, and how "federally approved" insurers would be treated.[11] The first October final rule confirmed the requirement that residual market entities and state workers compensation funds must participate in the program. The second October final rule finalized the disclosure and make-available requirements addressed in the April interim final rule.

[5] Ibid, p. 9805.

[6] Ibid., pp. 9805-9810.

[7] U.S. Dept. of the Treasury, "Terrorism Risk Insurance Program; Interim Final Rule and Proposed Rules," *Federal Register*, vol. 68, no. 75, April 18, 2003, pp. 19301-19308.

[8] Ibid., pp. 19303-19305.

[9] U.S. Dept. of the Treasury, "Terrorism Risk Insurance Program," *Federal Register*, vol. 68, no. 133, July 11, 2003, (hereinafter referred to as "July Final Rule"), pp. 41250-41266.

[10] U.S. Dept. of the Treasury, "Terrorism Risk Insurance Program; State Residual Market Insurance Entities," *Federal Register*, vol. 68, no. 201, Oct. 17, 2003, pp. 59715-59720, and U.S. Dept. of the Treasury, "Terrorism Risk Insurance Program; Disclosures and Mandatory Availability Requirements," *Federal Register*, vol. 68, no. 201, Oct. 17, 2003, pp. 59720-59727.

[11] July Final Rule, pp. 41252-41263.

Treasury's rulemaking for the program is not yet complete. In December 2003, a proposed rule[12] was published covering the procedures for filing claims should a covered event occur. It particularly "addresses requirements for loss certification and associated recordkeeping requirements; provides guidance on what is payable as the federal share of insured losses; and sets forth requirements for investigating and auditing claims under the Program."[13] The deadline for public comment was December 31, 2003. This proposed rule has yet to be finalized. In May 2004, another proposed rule was published.[14] This rule would implement Section 107 of the act on litigation management. The comment period on this rule ends July 6, 2004.

Why the Market Is Unsettled

Rates: Too High or Too Low?

No one knows what price to charge for the risk of losses due to an act of international terrorism. Though private companies have developed models for terrorism losses, many express skepticism about their predictive capacity, and all agree that determining the frequency of future U.S. insured losses due to acts of international terrorism is guesswork. That guesswork has important consequences for policyholders and the insurance marketplace. If insurers price the risk too high, then policyholders are unlikely to purchase the coverage, and insurers will have less premium to fund future losses for those — presumably higher risk — who do. If insurers price the risk too low, they risk insolvency and defaulting on policyholder claims. A private market will develop only if insurers can match each risk with a price that is neither too high nor too low.[15]

While no one knows what price should be charged, there is some information available about the relative price that is being charged for terrorism coverage: after substantial increases in the aftermath of September 11, 2001, prices have declined significantly for coverage in 2004.[16] For example, one source reported that premiums for terrorism coverage added to a property's overall property-casualty policy averaged 10% to 30% of the policy's cost in early 2003, down from 50% in late 2002.[17] Another reports that "the price of terrorism coverage is going down 'almost daily.'"[18] Rates for low-risk

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[12] U.S. Dept. of the Treasury, "Terrorism Risk Insurance Program; Initial Claims Procedures," *Federal Register*, vol. 68, no. 230, Dec. 1, 2003, pp. 67100-67106.

[13] Ibid, p. 67100.

[14] U.S. Dept. of the Treasury, "Terrorism Risk Insurance Program;Litigation Management," *Federal Register*, vol. 69, no. 88, May 6, 2004, pp. 25341-25348.

[15] Ben Dyson, "US Terrorism Insurance: Attempting the Impossible," *Reactions*, vol. 23, Jan. 2003, pp. 18-20.

[16] "Low losses, increased capacity help market moderate," *Business Insurance*, Jan. 12, 2004, p. 10.

[17] Gary Mogel, "Moody's 'snapshot': Terror premiums lower," *National Underwriter (Property and Casualty Edition)*, vol. 107, May 5, 2003, p. 18.

[18] Damian Testa, President, Kaye Associates, quoted in "Brokers' Client Survey Finds Pricing (continued...)

properties in small and mid-market accounts are reported at 1% to 5% of the base non-terror premium.[19] On the other hand, a recent GAO report concludes that only a minority of property-owners — between 10% and 30% — seem to be purchasing terrorism coverage.[20] There is some evidence that the capital markets may require terrorism coverage on properties that secure commercial mortgage-backed securities.[21]

What Happens If There's Another Attack?

Treasury is preparing systems and processes for certifying and paying claims, for determining insurers' and policyholders' shares, for auditing the program, for approving settlements, and for its other administrative tasks under TRIA and has released a proposed rule on initial claims procedures. Although some changes have been sought in the proposed rule,[22] Treasury's preparations have not sparked great controversy to date. It is likely, however, that in the event of losses due to another terrorist attack on the United States, such issues may become controversial. Other issues may arise post-attack as well; for example, insurers expect lawsuits from policyholders who declined to purchase coverage for acts of terrorism, alleging that they were not appropriately notified as required under TRIA. It is also likely that the cause of terrorist losses will be an issue, since TRIA does not cover acts of domestic terrorism and since insurance for terrorism losses under TRIA usually excludes nuclear, chemical, or biological losses.

Will a Private Market Develop?

Congress was clear in enacting TRIA that it expects a private market for terrorism insurance to develop before TRIA sunsets. It is unclear, and may remain so until the actual sunset of TRIA, whether a private market can or will develop. Reinsurers have re-entered the market only on a limited scale and prices remain high. Insurers themselves have reportedly made little progress toward developing any new forms of financing future losses due to terrorism.[23] On the other hand, some knowledgeable observers do believe that a private market can and will develop.[24] Treasury officials have repeatedly stated that they do expect a private market for terrorism coverage to develop and do not expect that the program will be renewed after it sunsets on December 31, 2005.[25]

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[18] (...continued)
and Solvency More a Concern than Terrorism," *BestWire*, Oct. 13, 2003.

[19] Gary Mogel, "Moody's Surveys Insurers on TRIA," *National Underwriter (Property and Casualty Edition)*, vol. 107, June 9, 2003, p. 34.

[20] U.S. General Accounting Office, *TERRORISM INSURANCE: Implementation of the Terrorism Risk Insurance Act of 2002*, GAO-04-307, (Washington: Apr. 23, 2004), p. 4.

[21] Wyn Jenkins, "No choice but to buy," *Reactions*, vol. 23, May 2003, p. 1.

[22] See, for example, "TRIA Claim Rule Questioned," *National Underwriter,Property & Casualty/Risk & Benefits Management Edition*, Jan. 19, 2004.

[23] GAO-04-307, p. 28.

[24] Russ Banham, "Freestanding Still," *Reactions*, vol. 23, Jan. 2003, pp. 21-22.

[25] Dennis Kelly, "Treasury Official Stresses Temporary Nature of Terror Insurance Backstop,"
(continued...)

Studies and Reports

TRIA directed the Secretary of the Treasury to study whether adequate and affordable reinsurance is available to group life insurers and the extent to which the threat of terrorism is reducing the availability of group life insurance. If the current or future availability of this insurance were reduced, the Secretary would be empowered to then allow group life insurers to participate in the program. This study's results were announced on August 15, 2003. Treasury concluded from the study that group life insurance availability was not curtailed, and was not likely to be curtailed in the future, and thus, it should not be included in the program. This decision disappointed many life insurers.[26]

In addition, TRIA required the Secretary to make two reports to Congress. The first report, due nine months after enactment, is to be on "the potential effects of acts of terrorism on the availability of life insurance and other lines of insurance, including personal lines."[27] The act directed the Secretary to consult on the study with the NAIC, representatives of the insurance industry, and other experts in the insurance field. Although the enactment of TRIA was over 17 months ago, this report has yet to be delivered to Congress. The second report, due by June 30, 2005, must include "the effectiveness of the Program and the likely capacity of the property and casualty insurance industry to offer insurance for terrorism risk after termination of the Program, and the availability and affordability of such insurance for various policyholders, including railroads, trucking, and public transit."[28] For this later report, the Secretary must consult with "other experts as needed" and with policyholders, as well as the parties consulted for the first study. As part of this consultation, Treasury is sending out surveys to the insurance industry to assess the terrorism risk insurance markets.

TRIA also directed the Secretary of the Treasury to determine by September 1, 2004, whether to extend to the end of 2005 the requirement that insurers must make terrorism coverage available. While TRIA does not require the Secretary to formally report to Congress on the make available determination, Congressional interest in this determination is high. Recent hearings have been held on TRIA in both the House and Senate. In these, witnesses from Treasury were repeatedly reminded of the importance of the provisions and the desire of some Members of Congress to see them extended. Acting well in advance of the September deadline, the Secretary indicated on June 18, 2004 that these provisions would be extended through 2005.

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[25] (...continued)
Bestwire, June 11, 2003; Marcia Kass, "Terror Insurance Program Temporary, Abernathy Says; Calls for FCRA Renewal," *BNA Daily Report for Executives*, no. 79, April 24, 2003, p. A-12.

[26] "Treasury Says No to Including Group Life in Federal Terrorism Backstop Program," *BestWire*, Aug. 19, 2003.

[27] P.L. 107-297, sec. 103(i)(1)-(2).

[28] P.L. 107-297, sec. 108(d)(1)-(2).