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# TERRORISM INSURANCE

## Effects of the Terrorism Risk Insurance Act of 2002

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Highlights of [GAO-04-806T](#), a testimony before the Senate Committee on Banking, Housing, and Urban Affairs.

## Why GAO Did This Study

After the terrorist attacks of September 11, 2001, insurance coverage for terrorism largely disappeared. Congress passed the Terrorism Risk Insurance Act (TRIA) in 2002 to help commercial property-casualty policyholders obtain terrorism insurance and give the insurance industry time to develop mechanisms to provide such insurance after the act expires on December 31, 2005. Under TRIA, the Department of Treasury (Treasury) caps insurer liability and would process claims and reimburse insurers for a large share of losses from terrorist acts that Treasury certified as meeting certain criteria. As Treasury and industry participants have operated under TRIA for more than a year, GAO was asked to assess Treasury's progress in implementing TRIA and describe how TRIA affected the terrorism insurance market.

## What GAO Recommends

GAO recommends that the Secretary of the Treasury, as part of Treasury's study of the effectiveness of TRIA and after consultation with insurance industry participants, identify for Congress alternatives that may exist for expanding the availability and affordability of terrorism insurance after TRIA expires. These alternatives could assist Congress during deliberations on the insurance industry's capacity to provide terrorism insurance.

[www.gao.gov/cgi-bin/getrpt?GAO-04-806T](http://www.gao.gov/cgi-bin/getrpt?GAO-04-806T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard Hillman at 202-512-8678, [hillmanr@gao.gov](mailto:hillmanr@gao.gov).

# TERRORISM INSURANCE

## Effects of the Terrorism Risk Insurance Act of 2002

### What GAO Found

Treasury and industry participants have made significant progress in implementing TRIA to date, although Treasury has important actions to complete in order to comply with its responsibilities under TRIA. Treasury has issued regulations on TRIA, created and staffed the Terrorism Risk Insurance Program office, and begun mandated studies and data collection efforts. However, Treasury has not yet made a decision on whether to extend the mandate that insurers "make available" terrorism coverage, using terms not differing materially from other coverage, for policies issued or renewed in 2005. Treasury's ongoing studies and data collection efforts will provide further insight into TRIA's effectiveness.

TRIA has enhanced the availability of terrorism insurance for commercial policyholders, largely fulfilling a principal objective of the legislation. In particular, TRIA has benefited commercial policyholders in major metropolitan areas perceived to be at greater risk for a terrorist attack, largely because of the requirement in TRIA that insurers offer coverage for terrorism. Prior to TRIA, GAO reported concern that some development projects had already been delayed or cancelled because of the unavailability of insurance and continued fears that other projects also would be adversely impacted. GAO also conveyed the widespread concern that general economic growth and development could be slowed by a lack of available terrorism insurance. Largely because of TRIA, these problems no longer appear to be major concerns.

Despite increased availability of coverage, limited industry data suggest that most commercial policyholders are not buying terrorism insurance, perhaps because they perceive their risk of losses from a terrorist act as being relatively low. The potential negative effects of low purchase rates, in combination with the probability that those most likely to be the targets of terrorist attacks may also be the ones most likely to have purchased coverage, would become evident only in the aftermath of a terrorist attack. Such negative effects could include more difficult economic recovery for businesses without terrorism coverage or potentially significant financial problems for insurers. Moreover, those that have purchased terrorism insurance may still be exposed to significant risks that have been excluded by insurance companies, such as nuclear, biological, or chemical events. Finally, although insurers and some reinsurers have cautiously reentered the terrorism risk market to cover insurers' remaining exposures, industry sources indicated no progress to date toward finding a reliable method for pricing terrorism insurance and little movement toward any mechanism that would enable insurers to provide terrorism insurance to businesses without government involvement.

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our report on the implementation of the Terrorism Risk Insurance Act of 2002 (TRIA) and the act's impact on the terrorism insurance market and, more generally, the economy.<sup>1</sup> The terrorist attacks of September 11, 2001, drastically changed the way insurers viewed the risk of terrorism. An industry that had considered the risk of terrorism so low that it did not identify or price terrorism risk separate from property and casualty coverage will ultimately pay approximately \$40 billion for losses arising from September 11, according to industry experts. Responding to terrorism risk after September 11, reinsurers began excluding terrorism from coverage as contracts between reinsurers and insurers came up for renewal.<sup>2</sup> Without reinsurance, insurers retained greater levels of risks than they could responsibly carry, and their reaction was to exclude these risks from commercial policies as they were renewed. In short, believing that neither the frequency nor magnitude of terrorism losses could be estimated, insurance companies withdrew from the market.

In the aftermath of September 11, we reported that terrorism insurance was disappearing in the marketplace, particularly for large businesses and those perceived to be at some risk.<sup>3</sup> We also reported significant concern that some development projects had already been delayed or cancelled because of the unavailability of insurance and fears that others would follow. Furthermore, there was widespread concern that general economic growth and development would be slowed by a lack of insurance availability and uncertainty in the marketplace. Because of concerns about the lack of available and affordable terrorism insurance,

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<sup>1</sup>U.S. General Accounting Office, *Terrorism Insurance: Implementation of the Terrorism Risk Insurance Act of 2002*, [GAO-04-307](#) (Washington, D.C.: Apr. 23, 2004), and *Terrorism Insurance: Effects of the Terrorism Risk Insurance Act of 2002*, [GAO-04-720T](#) (Washington, D.C.: Apr. 28, 2004).

<sup>2</sup>Reinsurance is a mechanism that insurance companies routinely use to spread risk associated with insurance policies. Simply put, it is insurance for insurance companies. Reinsurance is a normal business practice that satisfies a number of needs in the insurance marketplace, including the need to expand capacity and obtain protection against potential catastrophes.

<sup>3</sup>U.S. General Accounting Office, *Terrorism Insurance: Alternative Programs for Protecting Insurance Consumers*, [GAO-02-199T](#) (Washington, D.C.: Oct. 24, 2001), and *Terrorism Insurance: Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities*, [GAO-02-472T](#) (Washington, D.C.: Feb. 27, 2002).

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Congress passed TRIA, which took effect on November 26, 2002. TRIA is currently scheduled to expire at the end of 2005.

Our report on the implementation of TRIA has two objectives. First, we describe the progress made by the Department of the Treasury (Treasury) and insurance industry participants in implementing TRIA. Second, we discuss the changes in the market for terrorism insurance coverage under TRIA. As requested, my statement today discusses both of these objectives. Additionally, I have included an appendix to this statement that provides background information on TRIA.

In summary, Treasury and industry participants have made significant progress in implementing TRIA to date, although Treasury has important actions to complete in order to fully comply with its responsibilities under TRIA. Treasury's progress includes issuing regulations on TRIA, staffing the Terrorism Risk Insurance Program (TRIP) office, and beginning mandated studies and data collection efforts. For example, in compliance with one such study, Treasury decided not to extend TRIA to group life based on its determination that insurers had continued to provide group life coverage, although the availability of reinsurance was reduced. Treasury also issued proposed rules defining a framework for the claims process and litigation management under TRIA. Additionally, Treasury recently hired a contractor to provide claims payment services, according to a Treasury official. However, insurers have expressed reservations about Treasury's implementation of TRIA. Specifically, insurers are concerned about the potential length of time it may take for the Secretary of the Treasury to certify a terrorist event, potential inefficiencies and time lags in processing and paying claims once an event is certified, and TRIA's impending expiration at the end of 2005.<sup>4</sup> The industry has also expressed concern about the timing of Treasury's pending decision to extend the "make available" requirement to policies issued or renewed in 2005.<sup>5</sup>

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<sup>4</sup>TRIA provides that the Secretary of the Treasury, in concurrence with the Secretary of State and the Attorney General of the United States, shall determine whether an event should be certified as an act of terrorism, based on certain criteria. For example, "an individual or individuals acting on behalf of any foreign person or foreign interest" must commit the act. Under TRIA, insurers can claim reimbursement only for losses in events thus certified. See Appendix I for more information.

<sup>5</sup>TRIA defines "make available" to mean that the coverage must be offered for insured losses arising from terrorist events and that coverage not differ materially from the terms, amounts, and limitations applicable to coverage for losses arising from other types of events.

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TRIA has largely achieved Congress's first goal—to ensure that business activity did not suffer materially from a lack of available terrorism insurance. Since TRIA was enacted in November 2002, terrorism insurance generally has been available to businesses; however, most commercial policyholders are not buying terrorism coverage. According to insurance industry experts, purchase rates have been higher in areas considered to be at high risk of another terrorist attack. Many policyholders with businesses or properties not located in perceived high-risk locations may not be buying coverage because they view any price for terrorism insurance as high relative to their perceived risk exposure. Industry experts view overall low purchase rates in combination with a high concentration of purchases in areas thought to be most at risk as increasing the potential for negative effects should a terrorist event occur—either making economic recovery more difficult for those not insured or causing financial problems for insurers with many policies in the affected area. Further, those that have bought terrorism insurance remain exposed to significant perils because insurers have broadened longstanding policy exclusions for nuclear, biological, and chemical (NBC) events. Finally, Congress' second key goal in establishing TRIA—to give private industry a transitional period during which it could begin pricing terrorism insurance and develop ways to cover losses after TRIA expires—has not yet been achieved. Industry sources indicated that under TRIA, insurance market participants have made no progress to date toward the development of reliable methods for pricing terrorism risks and little movement toward any mechanism that would enable insurers to provide terrorism insurance to businesses without government involvement.

In conducting our work, we reviewed and analyzed relevant information concerning state legislation and publicly available and proprietary industry data and studies on the terrorism insurance market. We interviewed officials at Treasury, the National Association of Insurance Commissioners (NAIC), and state insurance regulators from six states with high insurance sales volumes. We also interviewed representatives of insurance companies, reinsurance companies, brokers for insurance and reinsurance companies, industry associations, property owners and developers, and insurance filing services and credit rating agencies.<sup>6</sup> In our discussions with these organizations, we endeavored to gain an understanding of their experience in implementing TRIA requirements, obtain their views on the effects of TRIA on the terrorism insurance market, and identify

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<sup>6</sup>Filing services perform many services for insurance companies, including submitting to state insurance regulators the documents required to sell a line of insurance.

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developments within the industry to address terrorism risks after TRIA expires. We conducted this work in Chicago, New York City, and Washington, D.C., from January 2003 through April 2004 in accordance with generally accepted government auditing standards.

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## **Treasury and Insurers Have Made Progress in Implementing TRIA, although Important Work Remains**

More than a year after TRIA's enactment, Treasury and insurance industry participants have made progress in implementing and complying with its provisions, although Treasury has yet to fully implement the 3-year program. Treasury has issued regulations (final rules) to guide insurance market participants, fully staffed the TRIP office, and begun collecting data and performing studies mandated by TRIA. For example, Treasury complied with a mandate to collect and assess data on the availability of group life insurance and reinsurance; based on that data, Treasury determined that group life would not be covered by TRIA. However, Treasury has yet to make the claims payment function fully operational, although it has recently hired contractors to perform claims payment functions. Moreover, even though the act does not require Treasury to make a decision about whether to extend the "make available" requirement through 2005 until September of this year, some insurers expressed concerns about whether such a late decision would allow them sufficient time to make and implement changes to policy rates and terms. Additionally, insurers have voiced concerns about the time Treasury might take to certify an act of terrorism as eligible for reimbursement under TRIA and pay claims after an act was certified. Finally, as TRIA's midpoint nears, many insurers and other market participants are concerned whether TRIA will be extended or not and the timing of such a decision.

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## **Treasury Has Issued Regulations, Staffed the TRIP Office, and Begun Studies and Data Collection Efforts**

To implement TRIA and make TRIP functional, Treasury has taken numerous regulatory and administrative actions that include rulemaking, staffing a program office, and collecting and analyzing data. To date, Treasury has issued several final and proposed rules to implement TRIA; these rules were preceded by four sets of interim guidance issued between December 2002 and March 2003 to address time-sensitive requirements. As of March 1, 2004, Treasury had issued three final rules that provided uniform definitions of TRIA terms, explained disclosure (that is, notification to policyholder) requirements, and determined which insurers were subject to TRIA. Currently, Treasury is soliciting public comments on additional proposed rules addressing claims processes and litigation management issues. Also, as of September 2003 Treasury had fully staffed the TRIP office. The office develops and oversees the operational aspects of TRIA, which encompass claims management—processing, review, and payment—and auditing functions. Staff will also oversee operations

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performed by the contractors that actually pay claims and audit insurers that have filed claims. Additionally, TRIP staff perform ongoing work such as issuing interpretive letters in response to questions submitted by the public and educating regulators, industry participants and the public about TRIA provisions.

Treasury completed a TRIA-mandated study on group life insurance and has begun other mandated studies and data collection efforts. Specifically, TRIA mandated that Treasury provide information to Congress in four areas: (1) the effects of terrorism on the availability of group life insurance, (2) the effects of terrorism on the availability of life and other lines of insurance, (3) annual data on premium rates, and (4) the effectiveness of TRIA. After Treasury completed an assessment of the availability of group life insurance and reinsurance, it decided not to make group life insurance subject to TRIA because it found that insurers had continued to provide group life coverage, although the availability of reinsurance was reduced.<sup>7</sup> Treasury has not yet reported to Congress the results of a mandated study concerning the effects of terrorism on the availability of life and other lines of insurance. The study was to have been completed by August 2003, but as of March 2004 the report had not been issued. Also, in November 2003 and January 2004, Treasury began sending surveys to buyers and sellers, respectively, of insurance to collect data on annual premium rates as well as other information for the study that will assess the effectiveness of TRIA.

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### Treasury Has Tasks to Complete before TRIA Can Be Fully Implemented

Before TRIA will be fully implemented, Treasury has to make certain decisions and make additional TRIP functions operational. As of April 2004, Treasury had not yet decided whether to extend the “make available” requirement to policies issued or renewed in 2005. TRIA gave Treasury until September 1, 2004, to decide if the “make available” requirement should be extended for policies issued or renewed in 2005, the third and final year of the act. Treasury did clarify in a press release that the “make available” requirement for annual policies issued or renewed in 2004

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<sup>7</sup>According to life insurance experts, life insurers have continued to sell group life policies in order to maintain customer relations that would be difficult to reestablish if the coverage were discontinued. Additionally, life insurance experts noted that business from other lines of insurance would be lost if insurers were to discontinue group life, which is typically sold as part of a package with disability and medical coverage.

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extends until the policy expiration date, even though the coverage period extends into 2005.

In addition, Treasury has not fully established a claims processing and payment structure. Treasury has issued a proposed rule that would establish an initial framework for the claims process, which includes procedural and recordkeeping requirements for insurers. However, the actual claims processing and payment function is not fully operational. A Treasury official said it has recently hired a contractor that would perform payment functions in the aftermath of a terrorist attack, but has not yet written regulations to cover the latter stages of the claims process such as adjusting over- and underpayments or hired a separate contractor to review claims and audit insurers after an event to ensure that underlying documents adequately support the claims paid by Treasury. Treasury officials anticipate awarding this audit and review contract in the fourth quarter of fiscal year 2004.

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### Insurers Have Expressed Some Concerns Related to TRIA's Implementation

Insurers have expressed some concerns about Treasury's implementation of TRIA. Insurers are concerned that Treasury has not already made a decision about extending the "make available" requirement through 2005. They are also concerned about the potential length of time it may take for the Secretary of the Treasury to certify a terrorist event, potential inefficiencies and time lags in processing and paying claims once an event is certified, and the issue of TRIA expiration. As discussed already, TRIA gives Treasury until September 2004 to make a decision about the "make available" requirement for policies issued or renewed in 2005. Insurers have stated that this deadline does not give them enough time to make underwriting decisions and evaluate and possibly revise prices and terms, actions they normally would want to undertake in mid-2004. Moreover, in most states insurers will have to obtain regulatory approval for such changes because TRIA's preemption of the states' authority to approve insurance policy rates and conditions expired on December 31, 2003. Thus, insurers are concerned that delay of Treasury's announcement on the "make available" extension until the legal deadline may cost both companies and policyholders money because policy changes will not be implemented in time to issue or renew policies.

Insurers are also concerned that delays in the payment of claims by Treasury, whether because of the length of time taken to certify that an act of terrorism met the requirements for federal reimbursement or to process and pay claims, might seriously impact insurer cash flows or, in certain circumstances, solvency. While TRIA does not specify the length of time available for determining whether an event meets the criteria for



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certification, an NAIC official told us that insurers are bound by law and regulations in most states to pay claims in a timely manner. As a result, an insurer may have to pay policyholder claims in full while still awaiting a certification decision, which could create a cash flow problem for insurers. Insurers identified the anthrax letter incidents as an example where law enforcement officials still have not identified the source, whether foreign or domestic, more than 2 years after the incidents. Moreover, if Treasury decided not to certify an event after insurers had already paid policyholder claims, some insurers could become insolvent. Unless the policyholder had paid for coverage of all terrorist events—including those caused by domestic terrorists, which would be excluded from reimbursement under TRIA—insurers would have paid for losses for which they had collected no premium. An NAIC official explained that insurers would have no way to recover payments already made to policyholders for losses associated with the event other than to seek remedies through the courts. Treasury officials have said that they understand the difficulties facing insurers but cannot impose a time frame on the certification process because it could involve complex fact-finding processes. To facilitate the certification process, Treasury has met with relevant individuals within the Department of Justice and the Department of State to discuss their roles in the certification process. Insurers are similarly concerned that the length of time Treasury may take to process and pay claims could impact insurers' cash flow. In response to this concern, Treasury has decided to use electronic fund transfers to insurer's accounts to speed reimbursement to insurers with approved claims. Treasury expects this method could speed payment of claims and reduce potential cash flow problems for insurers.

Finally, insurance industry officials are worried that uncertainty about the extension of TRIA past its stated expiration date of December 2005 would impede their business and planning processes. Although TRIA does not contain any specific extension provisions, industry participants are concerned that a late decision on whether or not to extend TRIA would deny them the time needed to tailor business operations and plans to an insurance environment that either would or would not contain TRIA.

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## Although Available, Few Are Buying Terrorism Insurance and the Industry Has Made Little Progress Toward Post-TRIA Coverage

While TRIA has improved the availability of terrorism insurance, particularly for high-risk properties in major metropolitan areas, most commercial policyholders are not buying the coverage. Limited industry data suggest that 10–30 percent of commercial policyholders are purchasing terrorism insurance, perhaps because most policyholders perceive themselves at relatively low risk for a terrorist event. Some industry experts are concerned that those most at risk from terrorism are generally the ones buying terrorism insurance. In combination with low purchase rates, these conditions could result in uninsured losses for those businesses without terrorism coverage or cause financial problems for insurers, should a terrorist event occur. Moreover, even policyholders who have purchased terrorism insurance may remain uninsured for significant risks arising from certified terrorist events—that is, those meeting statutory criteria for reimbursement under TRIA—such as those involving NBC agents or radioactive contamination. Finally, although insurers and some reinsurers have cautiously reentered the terrorism risk market, insurance industry participants have made little progress toward developing a mechanism that could permit the commercial insurance market to resume providing terrorism coverage without a government backstop.

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## TRIA Has Improved the Availability of Terrorism Insurance, Particularly for Some High-Risk Policyholders

TRIA has improved the availability of terrorism insurance, especially for some high-risk policyholders. According to insurance and risk management experts, these were the policyholders who had difficulty finding coverage before TRIA. TRIA requires that insurers “make available” coverage for terrorism on terms not differing materially from other coverage. Largely because of this requirement, terrorism insurance has been widely available, even for development projects in high-risk areas of the country. Although industry data on policyholder characteristics are limited and cannot be generalized to all policyholders in the United States, risk management and real estate representatives generally agree that after TRIA was passed, policyholders—including borrowers obtaining mortgages for “trophy” properties, owners and developers of high-risk properties in major city centers, and those in or near “trophy” properties—were able to purchase terrorism insurance.

Additionally, TRIA contributed to better credit ratings for some commercial mortgage-backed securities. For example, prior to TRIA’s passage, the credit ratings of certain mortgage-backed securities, in which the underlying collateral consisted of a single high-risk commercial property, were downgraded because the property lacked or had inadequate terrorism insurance. The credit ratings for other types of

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mortgage-backed securities, in which the underlying assets were pools of many types of commercial properties, were also downgraded but not to the same extent because the number and variety of properties in the pool diversified their risk of terrorism. Because TRIA made terrorism insurance available for the underlying assets, thus reducing the risk of losses from terrorist events, it improved the overall credit ratings of mortgage-backed securities, particularly single-asset mortgage-backed securities. Credit ratings affect investment decisions that revolve around factors such as interest rates because higher credit ratings result in lower costs of capital. According to an industry expert, investors use credit ratings as guidance when evaluating the risk of mortgage-backed securities for investment purposes. Higher credit ratings reflect lower credit risks. The typical investor response to lower credit risks is to accept lower returns, thereby reducing the cost of capital, which translates into lower interest rates for the borrower.

To the extent that the widespread availability of terrorism insurance is a result of TRIA's "make available" requirement, Treasury's decision on whether to extend the requirement to year three of the program is vitally important. While TRIA has ensured the availability of terrorism insurance, we have little quantitative information on the prices charged for this insurance. Treasury is engaged in gathering data through surveys that should provide useful information about terrorism insurance prices. TRIA requires that they make the information available to Congress upon request. In addition, TRIA also requires Treasury to assess the effectiveness of the act and evaluate the capacity of the industry to offer terrorism insurance after its expiration. This report is to be delivered to Congress no later than June 30, 2005.

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### Most Policyholders Have Not Bought Terrorism Insurance

Although TRIA improved the availability of terrorism insurance, relatively few policyholders have purchased terrorism coverage. We testified previously that prior to September 11, 2001, policyholders enjoyed "free" coverage for terrorism risks because insurers believed that this risk was so low that they provided the coverage without additional premiums as part of the policyholder's general property insurance policy. After September 11, prices for coverage increased rapidly and, in some cases, insurance became very difficult to find at any price. Although a purpose of TRIA is to make terrorism insurance available and affordable, the act does not specify a price structure.

However, experts in the insurance industry generally agree that after the passage of TRIA, low-risk policyholders (for example, those not in major

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urban centers) received relatively low-priced offers for terrorism insurance compared to high-risk policyholders, and some policyholders received terrorism coverage without additional premium charges.<sup>8</sup> Yet according to insurance experts, despite low premiums, many businesses (especially those not in “target” localities or industries) did not buy terrorism insurance. Some simply may not have perceived themselves at risk from terrorist events and considered terrorism insurance, even at low premiums (relative to high-risk areas), a bad investment.<sup>9</sup> According to insurance sources, other policyholders may have deferred their decision to buy terrorism insurance until their policy renewal date.

Some industry experts have voiced concerns that low purchase rates may indicate adverse selection—where those at the most risk from terrorism are generally the only ones buying terrorism insurance. Although industry surveys are limited in their scope and not appropriate for marketwide projections, the surveys are consistent with each other in finding low “take-up” rates, the percentage of policyholders buying terrorism insurance, ranging from 10 to 30 percent. According to one industry survey, the highest take-up rates have occurred in the Northeast, where premiums were generally higher than the rest of the country.

The combination of low take-up rates and high concentration of purchases in an area thought to be most at risk raises concerns that, depending on its location, a terrorist event could have additional negative effects.

- If a terrorist event took place in a location not thought to be a terrorist “target,” where most businesses had chosen not to purchase terrorism insurance, then businesses would receive little funding from insurance claims for business recovery efforts, with consequent negative effects on owners, employers, suppliers, and customers.
- Alternatively, if the terrorist event took place in a location deemed to be a “target,” where most businesses had purchased terrorism insurance, then adverse selection could result in significant financial

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<sup>8</sup>According to industry experts, the insurers that provided “free” terrorism insurance likely did so for policies already in place at the time TRIA was enacted and may have deferred operational changes and difficult pricing decisions because they lacked the resources to do so.

<sup>9</sup>Howard Kunreuther, Erwann Michel-Kerjan, and Beverly Porter, *Assessing, Managing and Financing Extreme Events: Dealing with Terrorism* (National Bureau of Economic Research: December 2003), 13.

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problems for insurers. A small customer base of geographically concentrated, high-risk policyholders could leave insurers unable to cover potential losses, facing possible insolvency. If, however, a higher percentage of business owners had chosen to buy the coverage, the increased number of policyholders would have reduced the chance that losses in any one geographic location would create a significant financial problem for an insurer.<sup>10</sup>

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### Tighter Exclusions Leave Policyholders Exposed to Significant Perils

Since September 11, 2001, the insurance industry has moved to tighten long-standing exclusions from coverage for losses resulting from NBC attacks and radiation contamination. As a result of these exclusions and the actions of a growing number of state legislatures to exclude losses from fire following a terrorist attack, even those policyholders who choose to buy terrorism insurance may be exposed to potentially significant losses. Although NBC coverage was generally not available before September 11, after that event insurers and reinsurers recognized the enormity of potential losses from terrorist events and introduced new practices and tightened policy language to further limit as much of their loss exposures as possible. (We discuss some of these practices and exclusions in more detail in the next section.) State regulators and legislatures have approved these exclusions, allowing insurers to restrict the terms and conditions of coverage for these perils. Moreover, because TRIA's "make available" requirements state that terms for terrorism coverage be similar to those offered for other types of policies, insurers may choose to exclude the perils from terrorism coverage just as they have in other types of coverage. According to Treasury officials, TRIA does not preclude Treasury from providing reimbursement for NBC events, if insurers offered this coverage. However, policyholder losses from perils excluded from coverage, such as NBCs, would not be "insured losses" as defined by TRIA and would not be covered even in the event of a certified terrorist attack.

In an increasing number of states, policyholders may not be able to recover losses from fire following a terrorist event if the coverage in those states is not purchased as part of the offered terrorism coverage. We have previously reported that approximately 30 states had laws requiring coverage for "fire-following" an event—known as the standard fire policy

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<sup>10</sup>Casualty Actuarial Society, *Foundations of Casualty Actuarial Science*, 4th ed. (United Book Press, Inc.: 2001), 51, 86.

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## Reinsurers Have Cautiously Returned to the Market, but Many Insurers Have Not Bought Reinsurance

(SFP)—irrespective of the fire’s cause. Therefore, in SFP states fire following a terrorist event is covered whether there is insurance coverage for terrorism or not. After September 11, some legislatures in SFP states amended their laws to allow the exclusion of fire following a terrorist event from coverage. As of March 1, 2004, 7 of the 30 SFP states had amended their laws to allow for the exclusion of acts of terrorism from statutory coverage requirements.<sup>11</sup> However as discussed previously, the “make available” provision requires coverage terms offered for terrorist events to be similar to coverage for other events. Treasury officials explained that in all non-SFP states, and the seven states with modified SFPs, insurers must include in their offer of terrorism insurance coverage for fire following a certified terrorist event because coverage for fire is part of the property coverage for all other risks. Thus, policyholders who have accepted the offer would be covered for fire following a terrorist event, even though their state allows exclusion of the coverage. However, policyholders who have rejected their offer of coverage for terrorism insurance would not be covered for fire following a terrorist event. According to insurance experts, losses from fire damage can be a relatively large proportion of the total property loss. As a result, excluding terrorist events from SFP requirements could result in potentially large losses that cannot be recovered if the policyholder did not purchase terrorism coverage. For example, following the 1994 Northridge earthquake in California, total insured losses for the earthquake were \$15 billion—\$12.5 billion of which were for fire damage. According to an insurance expert, policyholders were able to recover losses from fire damage because California is an SFP state, even though most policies had excluded coverage for earthquakes.

Under TRIA, reinsurers are offering a limited amount of coverage for terrorist events for insurers’ remaining exposures, but insurers have not been buying much of this reinsurance. According to insurance industry sources, TRIA’s ceiling on potential losses has enabled reinsurers to return cautiously to the market. That is, reinsurers generally are not offering coverage for terrorism risk beyond the limits of the insurer deductibles and the 10 percent share that insurers would pay under TRIA (see app. I). In spite of reinsurers’ willingness to offer this coverage, company representatives have said that many insurers have not purchased

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<sup>11</sup> According to the National Association of Mutual Insurance Companies, Louisiana, Michigan, Minnesota, Nebraska, New Hampshire, Oklahoma, and Virginia have amended their standard fire policies to allow for exclusion of terrorism from statutory fire coverage. State legislators in Massachusetts have introduced a similar bill.

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reinsurance. Insurance experts suggested that the low demand for the reinsurance might reflect, in part, commercial policyholders' generally low take-up rates for terrorism insurance. Moreover, insurance experts also have suggested that insurers may believe that the price of reinsurance is too high relative to the premiums they are earning from policyholders for terrorism insurance.

The relatively high prices charged for the limited amounts of terrorism reinsurance available are probably the result of interrelated factors. First, even before September 11 both insurance and reinsurance markets were beginning to harden; that is, prices were beginning to increase after several years of lower prices. Reinsurance losses resulting from September 11 also depressed reinsurance capacity and accelerated the rise in prices.<sup>12</sup> The resulting hard market for property-casualty insurance affected the price of most lines of insurance and reinsurance. A notable example has been the market for medical malpractice insurance.<sup>13</sup> The hard market is only now showing signs of coming to an end, with a resulting stabilization of prices for most lines of insurance. In addition to the effects of the hard market, reinsurer awareness of the adverse selection that may be occurring in the commercial insurance market could be another factor contributing to higher reinsurance prices. Adverse selection usually represents a larger-than-expected exposure to loss. Reinsurers are likely to react by increasing prices for the terrorism coverage that they do sell.

In spite of the reentry of reinsurers into the terrorism market, insurance experts said that without TRIA caps on potential losses, both insurers and reinsurers likely still would be unwilling to sell terrorism coverage because they have not found a reliable way to price their exposure to terrorist losses. According to industry representatives, neither insurers nor reinsurers can estimate potential losses from terrorism or determine prices for terrorism insurance without a pricing model that can estimate both the frequency and the severity of terrorist events. Reinsurance experts said that current models of risks for terrorist events do not have enough historical data to dependably estimate the frequency or severity of terrorist events, and therefore cannot be relied upon for pricing terrorism insurance. According to the experts, the models can predict a likely range

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<sup>12</sup>Capacity is the amount of reinsurance or insurance that is available for a defined risk.

<sup>13</sup>U.S. General Accounting Office, *Medical Malpractice Insurance: Multiple Factors Have Contributed to Increased Premium Rates*, [GAO-03-702](#) (Washington, D.C.: June 27, 2003).

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of insured losses resulting from the damage if specific event parameters such as type and size of weapon and location are specified. However, the models are unable to predict the probability of such an attack.

Even as they are charging high prices, reinsurers are covering less. In response to the losses of September 11, industry sources have said that reinsurers have changed some practices to limit their exposures to acts of terrorism. For example, reinsurers have begun monitoring their exposures by geographic area, requiring more detailed information from insurers, introducing annual aggregate and event limits, excluding large insurable values, and requiring stricter measures to safeguard assets and lives where risks are high.<sup>14</sup> And as discussed previously, almost immediately after September 11 reinsurers began broadening NBC exclusions beyond scenarios involving industrial accidents, to include events such as nuclear plant accidents and chemical spills and encompass intentional destruction from terrorists. For example, post-September 11 exclusions for nuclear risks include losses from radioactive contamination to property and radiation sickness from dirty bombs.

As of March 1, 2004, industry sources indicated that there has been little development or movement among insurers or reinsurers toward developing a private-sector mechanism that could provide capacity, without government involvement, to absorb losses from terrorist events. Industry officials have said that their level of willingness to participate more fully in the terrorism insurance market in the future will be determined, in part, by whether any more events occur. Industry sources could not predict if reinsurers would return to the terrorism insurance market after TRIA expires, even after several years and in the absence of further major terrorist attacks in the United States. They explained that reinsurers are still recovering from the enormous losses of September 11 and still cannot price terrorism coverage. In the long term and without another major terrorist attack, insurance and reinsurance companies might eventually return. However, should another major terrorist attack take place, reinsurers told us that they would not return to this market—with or without TRIA.

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<sup>14</sup>Christian Brauner and Georges Galey, "Terrorism Risks in Property Insurance and Their Insurability after 11 September 2001," (Swiss Reinsurance Company: 2003), 25.



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## Conclusions

Congress had two major objectives in establishing TRIA. The first was to ensure that business activity did not suffer from the lack of insurance by requiring insurers to continue to provide protection from the financial consequences of another terrorist attack. Since TRIA was enacted in November 2002, terrorism insurance generally has been widely available even for development projects in high-risk areas of the country, in large part because of TRIA's "make available" requirement. Although most businesses are not buying coverage, there is little evidence that commercial development has suffered to a great extent—even in lower-risk areas of the county, where purchases of coverage may be lowest. Further, although quantifiable evidence is lacking on whether the availability of terrorism coverage under TRIA has contributed to the economy, the current revival of economic activity suggests that the decision of most commercial policyholders to decline terrorism coverage has not resulted in widespread, negative economic effects. As a result, the first objective of TRIA appears largely to have been achieved.

Congress's second objective was to give the insurance industry a transitional period during which it could begin pricing terrorism risks and developing ways to provide such insurance after TRIA expires. The insurance industry has not yet achieved this goal. We observed after September 11 the crucial importance of reinsurers for the survival of the terrorism insurance market and reported that reinsurers' inability to price terrorism risks was a major factor in their departure from the market. Additionally, most industry experts are tentative about predictions of the level of reinsurer and insurer participation in the terrorism insurance market after TRIA expires. Unfortunately, insurers and reinsurers still have not found a reliable method for pricing terrorism insurance, and although TRIA has provided reinsurers the opportunity to reenter the market to a limited extent, industry participants have not developed a mechanism to replace TRIA. As a result, reinsurer and consequently, insurer, participation in the terrorism insurance market likely will decline significantly after TRIA expires.

Not only has no private-sector mechanism emerged for supplying terrorism insurance after TRIA expires, but to date there also has been little discussion of possible alternatives for ensuring the availability and affordability of terrorism coverage after TRIA expires. Congress may benefit from an informed assessment of possible alternatives—including both wholly private alternatives and alternatives that could involve some government participation or action. Such an assessment could be a part of Treasury's TRIA-mandated study to "assess...the likely capacity of the

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property and casualty insurance industry to offer insurance for terrorism risk after termination of the Program.”

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## Recommendation for Executive Action

As part of the response to the TRIA-mandated study that requires Treasury to assess the effectiveness of TRIA and evaluate the capacity of the industry to offer terrorism insurance after TRIA expires, we recommend that the Secretary of the Treasury, after consulting with the insurance industry and other interested parties, identify for Congress an array of alternatives that may exist for expanding the availability and affordability of terrorism insurance after TRIA expires. These alternatives could assist Congress during its deliberations on how best to ensure the availability and affordability of terrorism insurance after December 2005.

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Mr. Chairman, this concludes my prepared statement, and I would be pleased to respond to any questions that you or other members of the Committee may have.

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## Contacts and Acknowledgments

For further information regarding this testimony please contact Richard J. Hillman, Director, or Lawrence D. Cluff, Assistant Director, Financial Markets and Community Investment, (202) 512-8678. Individuals making key contributions to this testimony include Rachel DeMarcus, Barry Kirby, Tarek Mahmassani, Angela Pun, and Barbara Roesmann.

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# Appendix I: TRIA Background

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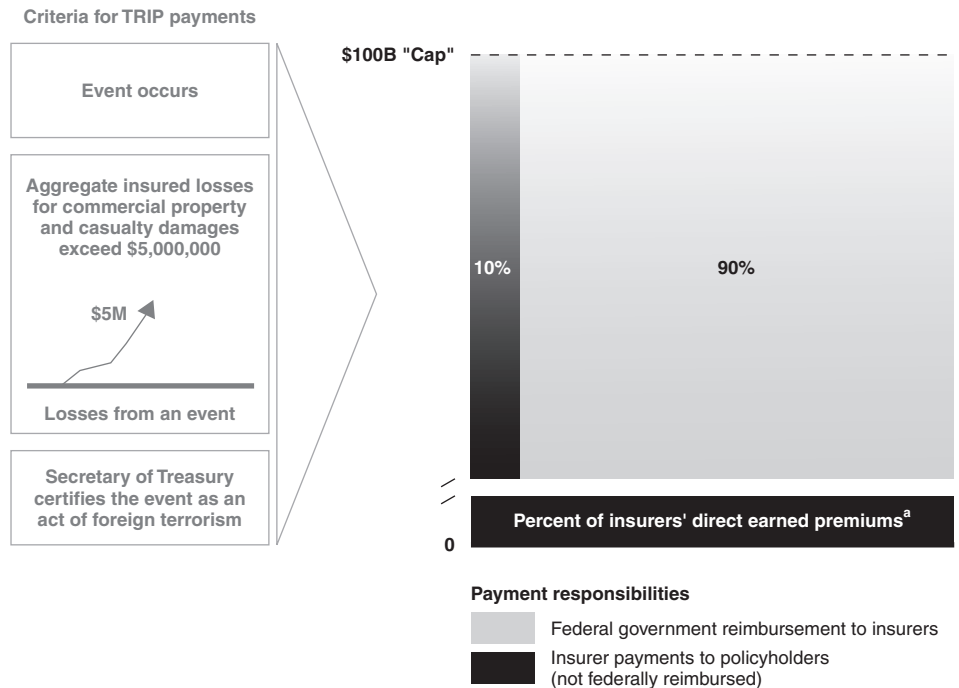
Under TRIA, Treasury is responsible for reimbursing insurers for a portion of terrorism losses under certain conditions. Payments are triggered when (1) the Secretary of the Treasury certifies that terrorists acting on behalf of foreign interests have carried out an act of terrorism and (2) aggregate insured losses for commercial property and casualty damages exceed \$5,000,000 for a single event.<sup>1</sup> TRIA specifies that an insurer is responsible (that is, will not be reimbursed) for the first dollars of its insured losses—its deductible amount. TRIA sets the deductible amount for each insurer equal to a percentage of its direct earned premiums for the previous year.<sup>2</sup> Beyond the deductible, insurers also are responsible for paying a percentage of insured losses. Specifically, TRIA structures pay-out provisions so that the federal government shares the payment of insured losses with insurers at a 9:1 ratio—the federal government pays 90 percent of insured losses and insurers pay 10 percent—until aggregate insured losses from all insurers reach \$100 billion in a calendar year (see fig. 1). Thus, under TRIA’s formula for sharing losses, insurers are reimbursed for portions of the claims they have paid to policyholders. Furthermore, TRIA then releases insurers who have paid their deductibles from any further liability for losses that exceed aggregate insured losses of \$100 billion in any one year. Congress is charged with determining how losses in excess of \$100 billion will be paid.

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<sup>1</sup>Aggregate insured losses are the sum of insured property and casualty losses from all commercial policyholders that result from a certified act of terrorism.

<sup>2</sup>Section 102(4) of TRIA defines direct earned premiums as “a direct earned premium for property and casualty insurance issued by any insurer for insurance against losses ...” Treasury provided further clarification that direct earned premiums are “earned as reported to the NAIC in the Annual Statement in column 2 of Exhibit of Premiums and Losses (commonly known as Statutory Page 14)” and cover all risks, not only for risks from terrorism. The percentage of the direct earned premium allowed as an insurer deductible varies over the program years: 7 percent in 2003, 10 percent in 2004, and 15 percent in 2005.

**Figure 1: Prerequisites for and Limits of Coverage Under TRIA**



Source: GAO analysis of Terrorism Risk Insurance Act of 2002.

<sup>a</sup>The percentage of direct earned premiums increases each year: 7 percent in 2003, 10 percent in 2004, and 15 percent in 2005.

TRIA also contains provisions and a formula requiring Treasury to recoup part of the federal share if the aggregate sum of all insurers' deductibles and 10 percent share is less than the amount prescribed in the act—the "insurance marketplace aggregate retention amount." TRIA also gives the Secretary of the Treasury discretion to recoup more of the federal payment if deemed appropriate.<sup>3</sup> Commercial property-casualty policyholders would pay for the recoupment through a surcharge on

<sup>3</sup>According to Treasury officials, the formula for the mandatory portion of the recoupment is intended to ensure that the insurance industry is financially responsible for a prescribed level of the first dollars of losses. The prescribed loss levels are as follows: \$10 billion in 2003, \$12.5 billion in 2004, and \$15 billion in 2005. Therefore, if the sum of insurers' aggregate payments for deductibles and the 10 percent share—the amounts paid by industry—is less than the level prescribed for that year, then a recoupment would be required to collect the difference. On the other hand, if the amounts paid by industry exceed the prescribed level, then a recoupment would not be needed.

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premiums for all the property-casualty policies in force after Treasury established the surcharge amount; the insurers would collect the surcharge. TRIA limits the surcharge to a maximum of 3 percent of annual premiums, to be assessed for as many years as necessary to recoup the mandatory amount. TRIA also gives the Secretary of the Treasury discretion to reduce the annual surcharge in consideration of various factors such as the economic impact on urban centers. However, if Treasury makes such adjustments, it has to extend the surcharges for additional years to collect the remainder of the recoupment.

Treasury is funding the Terrorism Risk Insurance Program (TRIP) office—through which it administers TRIA provisions and would pay claims—with “no-year money” under a TRIA provision that gives Treasury authority to utilize funds necessary to set up and run the program.<sup>4</sup> The TRIP office had a budget of \$8.97 million for fiscal year 2003 (of which TRIP spent \$4 million), \$9 million for fiscal year 2004, and a projected budget of \$10.56 million for fiscal year 2005—a total of \$28.53 million over 3 years. The funding levels incorporate the estimated costs of running a claims-processing operation in the aftermath of a terrorist event: \$5 million in fiscal years 2003 and 2004 and \$6.5 million in fiscal year 2005, representing about 55–60 percent of the budget for each fiscal year. If no certified terrorist event occurs, the claims-processing function would be maintained at a standby level, reducing the projected costs to \$1.2 million annually, or about 23 percent of the office’s budget in each fiscal year. Any funds ultimately used to pay the federal share after a certified terrorist event would be in addition to these budgeted amounts.

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<sup>4</sup>“No-year money” is budget authority that remains available for obligation until expended, usually until the objectives for which the authority was made available are attained.

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