Is Terrorism an Insurable Risk?

By Eric Nordman, Director of Regulatory Services and CIPR

In the United States, the watershed moment for acts of terrorism came swiftly on Sept. 11, 2001. On that morning, four commercial airliners were hijacked and used as explosive devices with devastating results. Lower Manhattan was ablaze, with the attacks resulting in destruction of the iconic twin towers of the World Trade Center, along with other buildings. The loss of life was a staggering 2,606 in New York City alone. One of the four planes struck the Pentagon, causing significant damage and 125 deaths. The final plane crashed in a Pennsylvania cornfield after heroic efforts of passengers thwarted the hijackers' efforts to cause even more death and destruction to populated areas. There were 246 passengers and crew on the four airlines along with 19 hijackers for a total of 2,996 deaths that day. Insured losses (primarily commercial property and life insurance claims) reached a staggering amount exceeding $30 billion at the time. The world as we then knew it was forever changed.

Insurers reacted to the magnitude of the loss as they often do when catastrophes occur. They said they would cover the property and loss of life as provided in the current policy forms. However, they also noted that providing coverage of acts of terrorism in the future would be less likely. They then proceeded to cancel policies for perceived terrorism targets, draft exclusions and contract limitations and generally do what they could to mitigate their exposure to loss from acts of terrorism. The purpose of this article is to discuss the federal Terrorism Risk Insurance Act and its renewals in light of the most recent sunset, which will occur Dec. 31, 2014. The article will also discuss the question of whether acts of terrorism are insurable.

◆ The Terrorism Risk Insurance Program

The Terrorism Risk Insurance Act of 2002 created the Terrorism Risk Insurance Program (TRIP) within the U.S. Department of the Treasury. The original act was intended as a temporary federal program where the federal government shared the risk of terrorism losses with commercial property/casualty insurers. The act was intended to provide a level of consumer protection by ensuring the availability and affordability of insurance covering foreign acts of terrorism. The original program was to sunset in three years. However, the U.S. Congress has adopted two extensions to the program: one for a two-year extension and one for a seven-year extension. The original act and the first extension did not provide coverage for domestic acts of terrorism. The 2007 extension added that coverage.

The current TRIP provides a complicated hierarchy of steps that must be met before an insurer is eligible for reimbursement under the program. It starts with a certification process. The first threshold to meet is for an act of terrorism to be "certified." For certification, the act of terrorism must occur in the United States or on a U.S. air carrier or U.S. seagoing vessel. The terrorist act must also exceed $5 million in insured losses. The certification is done jointly by the secretary of the Treasury, the U.S. secretary of state and the U.S. attorney general.

The second step is for the insurance industry's aggregate certified insured losses to exceed $100 million. If the losses do not exceed that threshold, then there is no federal share in the loss.

Even if the certification occurs and the aggregate certified insured losses exceed $100 million, there are limitations to the types of insurance coverage that qualify for reimbursement under TRIP. The program covers only commercial lines property/casualty insurance and there are some limitations specified in the law. There is no coverage for federal crop insurance, private crop or livestock insurance, private mortgage insurance, title insurance, financial guaranty insurance, medical professional liability insurance, flood insurance, reinsurance and life insurance products. Generally, the thinking behind these exclusions is that it would be difficult, or even impossible, for a terrorist to create a loss that would be covered by the specified types policies.

Assuming the first three steps are met, an insurer can submit a claim under the program. Before the federal government will participate in the loss, the insurer must meet its deductible obligations under the program. The current deductible is set at 20% of the insurer's annual direct earned premiums for the covered lines of business.

The fifth step is where there is a payment made by the federal government. Once the loss is certified, the aggregate certified insured losses exceed $100 million and the insurer has met its 20% deductible obligations, then the federal government will pay 85% of the losses above the deductible amount. There is a sixth step that adds some uncertainty back into the mix. If the total amount of losses exceeds $100 billion, then the federal contribution ends, as there is a cap built into the legislation. Presumably, if that occurs, Congress will determine if more funds should be allocated to the program.

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◆ INSURABILITY OF ACTS OF TERRORISM

The recent successful terrorist attack near the finish line of the Boston Marathon reminds us that terrorism is never far away. Property damage estimates were unavailable at the time this was written. Thus, it is unknown whether the event will become a certified act of terrorism. Even if the event is certified, it is unlikely aggregate certified insured losses will exceed the $100 million threshold needed to trigger any payment by the federal government under TRIP. The attack caused several deaths and close to 200 injuries.

Several planned attacks have been foiled in recent years. The common thread in the Boston Marathon attack and the other recent unsuccessful attacks is the use of improvised explosive devices (IEDs). The IED is intended to produce mass casualties and strike fear in the citizens. Perhaps the best publicized of the unsuccessful attempts is the May 2010 car bomb in New York City's Times Square. Other unsuccessful attacks include:

- An undetonated IED discovered by authorities on the parade route of a planned Martin Luther King, Jr. Unity Marchs in Seattle, WA (2011);
- A foiled plot to detonate a car bomb at the annual Christmas Tree Lighting Ceremony in Portland, OR (November 2010);
- A foiled plot to attack the Washington, DC, Metrorail system (October 2010); and
- A foiled plot to attack the New York City subway using IEDs (September 2009).

From an insurance perspective, providing coverage for acts of terrorism is less than ideal. The insurance mechanism works best for events that are predictable. Things that occur frequently and are of low severity are most predictable and, therefore, the easiest for insurers to price. For example, auto physical damage is a predictable line of business. Many auto accidents occur each day and the most an insurer must pay is well known based on the cost to repair or replace the vehicle, which is easy to ascertain. Contrast that with acts of terrorism, which, thankfully, occur infrequently, are of unpredictable origin and range from modest damage to potentially billions of dollars in losses.

When faced with this level of uncertainty, insurers must rely on computer modeling to develop a price for the product. Modeling for terrorism losses is in its infancy. As a result, and all things being equal, insurers would prefer to underwrite coverages that are more predictable. Thus, insurers tend to shy away from providing coverage for acts of terrorism voluntarily. The TRIP provides insurers with the assurance they need to allow them to offer coverage for acts of terrorism. The TRIP gives insurers a boundary on their ultimate costs of insuring the risk. It provides the maximum probable loss statistic for ratemaking and solvency purposes. It is perhaps one of the most successful and least costly federal programs operating today. A small staff is involved in rulemaking and managing the program. There is a recoupment mechanism so, in most cases, losses paid for by the program would be reimbursed by a policyholder surcharge in future years.

Several studies have been conducted to evaluate the insurance markets for acts of terrorism. The President's Working Group on Financial Markets has published studies in 2006 (Terrorism Risk Insurance) and 2010 (Market Conditions for Terrorism Risk Insurance). These studies found that the cost of terrorism insurance was high following the events of 9/11, but it has come down some since then. The President's Working Group on Financial Markets found that the private insurance market's appetite for voluntarily offering terrorism coverage has improved, but its estimates regarding the level of capacity the industry is willing to devote to the terrorism risk are in the $6 billion to $8 billion range. This level of capitalization is inadequate to serve the needs of American businesses.

◆ CONCLUSION

While insurers are slightly more willing and able to insure acts of terrorism today than they were in 2002, the terrorism risk is challenging. While not completely uninsurable, there is not a sufficient private market available to serve the appetite for coverage from American businesses. Thus, if the TRIP is allowed to sunset at the end of 2014, we can expect many insurers to exclude or significantly limit coverage for acts of terrorism in property and liability insurance policies.

A timely renewal of TRIP by the U.S. Congress would avoid market dislocations and save considerable time and expense for insurers and insurance regulators. As they did for recent renewals, regulators expect insurers to file contingency endorsements for policies issued on or after Jan. 2, 2014. All of this effort and expense could be avoided if Congress were to act on a TRIP renewal this year.

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