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Report: The Need to Renew TRIA ABA TIPS Task Force on Federal Involvement in Insurance Regulation Modernization

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This Report support's the position by the ABA TIPS Task Force on Federal Involvement in Insurance Regulation Modernization that the Terrorism Risk Insurance Act (TRIA) should be renewed. Although the market for terrorism insurance has developed with the support of TRIA, the fundamental nature of terrorism risk has not changed and continues to require the Federal backstop. Because of the unpredictability of terrorism risk, without a Federal backstop many insurers will withdraw from the terrorism market, the price of terrorism insurance will rise and take-up rates will fall. Other countries facing terrorism risk, in some cases substantially less risk than the United States, have recognized the need for government involvement and have government programs. In fact, TRIA's use of a significant insurer and industry retentions, and the role of the Federal government as a "backstop" rather than as an insurer, makes TRIA one of the most "market" oriented terrorism insurance programs.

I. Summary Description of the Terrorism Risk Insurance Program

A. Legislative History

TRIA was adopted in 2002 after insurers and reinsurers began excluding terrorism risk from insurance coverage in the wake of the September 11, 2001, terrorist attacks.[1] The exclusion of terrorism risk created a drag on the U.S. economy because banks were unwilling to lend on major construction projects without terrorism insurance.[2]

In 2005, TRIA was extended.[3] In 2007, the Act was modified to include domestic terrorism and extended until 2014.[4]

B. Coverage Under the Terrorism Risk Insurance Program

Under current law, the terrorism insurance program requires that commercial property and casualty insurers[5] offer to include terrorism coverage in the policies they are selling. The program does not set the price of the insurance (though state regulation may apply), and does not require that insured's purchase terrorism coverage. For a terrorism loss to be covered by the program, it must be certified as an act of terrorism by the Secretary of the Treasury and must exceed $5 million in losses.[6] For an insurer to receive any benefits under the program, insurance industry losses from the terrorism event must

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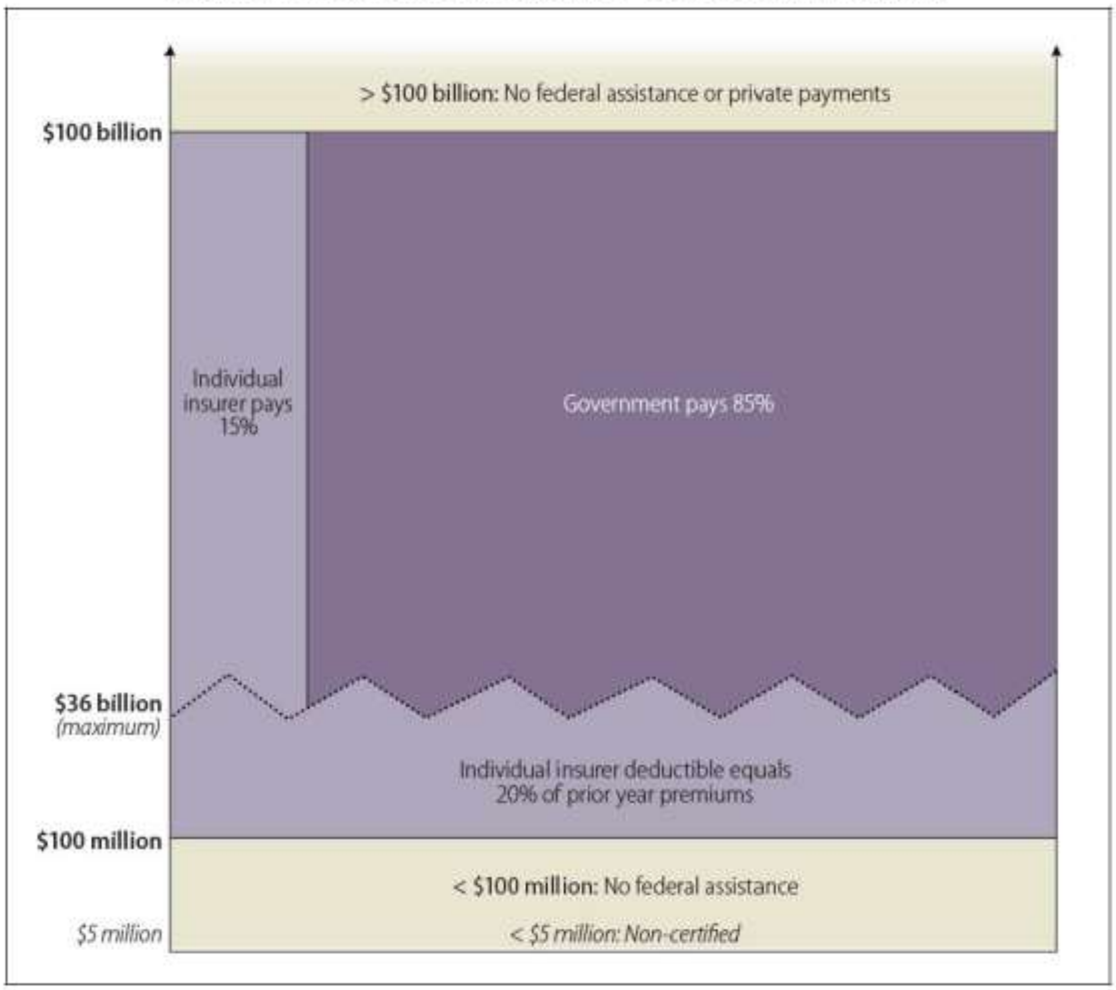
[1] *See* ABA TIPS Taskforce on Federal Involvement in Insurance Modernization, Whitepaper on Renewal of TRIA at 1 (March 15, 2006) (Attached as Appendix A) [hereinafter Whitepaper].
[2] *Id.* at 1-2.
[3] The Terrorism Risk Insurance Extension Act of 2005, Pub. L. 109-144, 119 Stat. 2660.
[4] Terrorism Risk Insurance Program Reauthorization Act of 2007, Pub. L. 110-160, 121 Stat. 1839. For side-by-side comparisons of the different laws and their impact on the evolution of the terrorism insurance program, see Baird Webel, Terrorism Risk Insurance: Issue Analysis and Overview of Current Program, Table 1, at 12-14 (Congressional Research Service, March 4, 2014).
[5] Some lines of property and casualty insurance are excluded from the program: crop, financial guaranty, flood, life, medical malpractice, mortgage, title and reinsurance. *See* 15 U.S.C. § 6701, Terrorism Insurance Program § 102 (12)(B).
[6] *See* id. § 102(1).

exceed $100 million.[7] In addition, each insurer must meet its own deductible equal to 20% of its annual direct earned premiums before it is entitled to benefits under the program.[8] Once the deductible has been met, insurers are reimbursed for 85% of insured terrorism losses[9] until total insured losses from the event reach $100 billion[10] (more than twice the losses from the September 11th attacks). If total insured losses exceed $100 billion, insurers are relieved of the obligation to make further payments for the loss.[11] Figure 1, adapted by the Congressional Research Service from an illustration prepared by the Congressional Budget Office, provides a graphical representation of how the program works:

Figure 1. Initial Loss Sharing Under Current TRIA Program



Source: Congressional Research Service, adapted from Congressional Budget Office, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization*, August 1, 2007, p. 12.

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[7] *See id*. § 103(e)(1)(B).
[8] *See id*. § 103(e)(2)(B)(i) and § 102(7).
[9] *See id*. § 103(e)(1)(A).
[10] *See id*. § 103(e)(2)(A).
[11] *See id*. § 103(e)(2)(A)(ii).

C. Recoupment of Federal Payouts Under the Program

The terrorism insurance program also includes provisions to recoup Federal payments from the insurance industry. If losses retained by insurers (due to the deductibles and insurer copayments) do not exceed $27.5 billion, the Secretary of the Treasury is required to impose surcharges on property and casualty insurance policies to recoup 133% of difference between the industry retention and $27.5 billion.[12] These surcharges are to be made under the program prior to Fiscal Year 2017.[13] If the losses retained by insurers exceed $27.5 billion (due to the deductibles and insurer copayments), no recoupment is required, but the Secretary has discretion to impose surcharges for recoupment in light of the costs to the taxpayers, the economic conditions in the insurance marketplace, the affordability of commercial insurance for small and medium-sized businesses, and other facts the Secretary considers appropriate.[14]

D. Backstop, not Reinsurance

The term "backstop" is used to describe this program because the Federal government stands behind the program, and facilitates it, but much of the risk, especially in the first instance, is borne by the insurance industry. Because of the deductibles, insurers bear the risk of terrorism losses up to 20% of their direct earned premium. The precise amount of this deductible will vary depending on the conditions in the marketplace and the sales of individual insurance companies, but it could be as much as $36 billion.[15]

Furthermore, the recoupment provisions provide that much or all of the government payments under the program would be recovered from insureds through premium surcharges. When insured losses are $27.5 billion or less, the government will recoup 133% of its payout.[16] If, for example, a terrorism event caused insured losses of $20 billion, assuming the insurance industry paid a deductible of $6 billion, the Federal share of the losses would be $11.9 billion (20 billion - 6 billion x .85), so the recoupment surcharges would be for $15.8 billion (11.9 billion x 1.33).[17] Where the losses exceed $27.5 billion, the

[12] *See id*. § 103(e)(7)(A). For calculations of estimated recoupment under different payout scenarios, see Webel, *supra* note 4, Appendix Table A-1, at 16.
[13] *See* 15 U.S.C. § 6701, Terrorism Insurance Program § 103(e)(7)(E)(i)(III).
[14] *See id*. § 103(e)(7)(D).
[15] This figure was obtained by using aggregate direct earned premium figures from the NAIC for 2012 for the commercial property-casualty insurance sector, *see* Webel, *supra* note 4, at 5, but to reach this figure, direct earned premiums would have to be evenly distributed among all insurers and all insurers would have to bear the same proportion of terrorism losses. These are very artificial assumptions, but they give some sense of maximum scope of the insurer deductibles.
[16] The statute says that the mandatory surcharge applies to the difference between the lesser of the aggregate amount the insured losses or $27.5 billion, *see* 15 U.S.C. § 6701, Terrorism Insurance Program § 103(e)(6), and the amount of the insured losses retained by the insurers under the deductible and copayment provisions, *see id.* § 103(e)(7)(A)(ii). Where the total losses are under $27.5 billion, this amount will always be the amount paid out by the government. *See* Webel, *supra* note 4, at Appendix, Table A-1, at 16.
[17] *See* Webel, *supra* note 4, at Appendix, Table A-1, at 16.

mandatory recoupment is limited to the difference between $27.5 billion and the total amount of the insurers' share of the losses (deductible plus copayments). Thus, if we assume a terrorism event with $50 billion in insured losses, and that the industry deductible is $15 billion, the remaining insured losses would be $35 billion. Of that amount, the insurers would be responsible for a copayment of $5.25 billion (50 billion – 15 billion x .15). The government's share would be $29.75 billion. Mandatory recoupment under this scenario would be $9.6425 billion (27.5 - 15 - 5.25 = 7.25 x 1.33 = 9.6425) .[18] Although this recoupment would leave the government responsible for more than $29 billion of the losses, the Secretary of Treasury also has discretionary authority to impose additional surcharges for additional recoupment.

These recoupment provisions make the program much different than traditional reinsurance, which is the transfer of risk from primary insurers to reinsurers in exchange for a premium payment. Here, while there is a transfer of sorts in the sense that the government pledges to reimburse some of the losses, the Federal government doesn't bear the risk in the same way as a reinsurer. The Federal government explicitly has the right to recover the payments through both mandatory and discretionary premium surcharges. In addition, the program does not charge any premiums. Instead of trying to predict the risks and potential costs in advance, this program pools the risk and then distributes the costs of a loss after the terrorism incident.

E. Use of Market Mechanisms

While the Federal backstop reduces the risk to a level that encourages insurers to underwrite terrorism risk, insurers maintain enough exposure under the program to create incentives for the operation of a terrorism insurance market. Insurers must bear 20% of their directed earned premiums as a deductible and another 15% of any losses as a copayment. Using 2012 data, the National Association of Insurance Commissioners determined that the insurer could face as much as $36 billion in exposure from the deductible provision.[19] In addition, insurers face additional billions in exposure from the copayment provision.[20] Thus, insurers easily face tens of billions in exposure, which is similar to the $23.9 billion in losses from the September 11th attack.[21] This exposure, which exists underneath the Federal backstop, is the space where the terrorism reinsurance market operates.

[18] *See* Webel, *supra* note 4, at Appendix, Table A-1, at 16.
[19] *See* Webel, *supra* note 4, at 5.
[20] The program has a hard cap of $100 billion. *See* 15 U.S.C. § 6701, Terrorism Insurance Program § 103(e)(2)(A). Insurers are reimbursed for 85% of losses (so retain 15% of the losses as a copayment). *See id.* § 103(e)(1)(A). Thus, maximum copayments are $15 billion ($100 billion x .15). To reach this figure, insurers would have to have no deductible at all, which would not happen.
[21] *See* Henry H. Willis, Omar Al-Shahery, National Security Perspectives on Terrorism Risk Insurance In the United States at iv (RAND Corporation March 2014)[hereinafter RAND II].

II. The Terrorism Insurance Program is Still Needed

A. Terrorism is Still Unpredictable

Although there is a functioning market for terrorism insurance and reinsurance at the present time, maintaining the Federal backstop is necessary to keep the market functioning. Fundamentally, terrorism risk is still highly unpredictable.[22] Acts of terrorism are deliberate, not accidental, undertaken with the intention of generating fear.[23] Terrorists may act in ways that are unexpected in order to generate more fear,[24] and have shown an increased willingness to attack "soft" targets.[25] Terrorists' willingness to commit suicide makes it more difficult to predict their behavior.[26] There is a relatively small amount of historical data on terrorism,[27] and those data are limited by the broad range of cultural, operational, and ideological differences in terrorist groups.[28] What data there are may be unavailable to insurance underwriters because of national security and law enforcement concerns.[29] While progress has been made in modeling terrorism risk[30] (in particular, the scope of damages from various terrorism scenarios), a review of current modeling efforts by the RAND Corporation, and independent research institute, concluded that "fundamental assumptions limit the validity of these [terrorism] models for predicting the future expected losses from the full range of terrorist events accurately enough to support an actuarial assessment of terrorism risk."[31]

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[22] *See* RAND II, *supra* note 21, at 8.
[23] *See* Whitepaper at 3; *see also* WHARTON RISK MANAGEMENT AND DECISION PROCESS CENTER, TRIA AND BEYOND, at 13 (2005) [hereinafter WHARTON].
[24] *See* Whitepaper at 3. This has been called the dynamic uncertainty problem. *See* WHARTON, *supra* note 16, at 52-53.
[25] *See* Whitepaper at 3; *see also* Peter Chalk, Bruce Hoffman, Robert Reville, Anna-Britt Kasupski, Trends in Terrorism: Trheats to the United States and the Future of the Terrorism Risk Insurance Act at 15-16, (2005) [hereinafter RAND I].
[26] *See* Whitepaper at 3; *see also* WHARTON, *supra* note 16, at 55-56.
[27] *See* Robert P. Hartwig, Reauthorizing TRIA: The State of the Terrorism Risk Insurance Market at 19 (September 25, 2013) (testimony before the US Senate Committee on Banking, Housing and Urban Affairs) (http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=8213e203-2743-4c66-a58d-6664c82c6857) (last visited on March 13, 2014).
[28] *See* Whitepaper at 3; WHARTON, *supra* note 16, at 58.
[29] *See* Whitepaper at 3; WHARTON, *supra* note 16, at 53-54.
[30] RAND II, *supra* note 21, at 11.
[31] RAND II, *supra* note 21, at 12. The fundamental assumptions that limit validity of the models are that there are a finite set of attack scenarios and that the intentions and capabilities of terrorism groups can be predicted. In fact, the possible range of scenarios is limitless and it is impossible to predict the intentions and capabilities of all individuals and groups that might undertake a terrorist act. *Id*. Another important limitation of the modeling pointed out by RAND is that validity and reliability of the models are completely untested. *Id*. This problem led the U.S. National Academic of Sciences to conclude, "after reviewing a wide range of terrorism risk models at the Department of Homeland Security . . . that it 'did not find any Department of Homeland Security [terrorism]risk analysis capability and methods that are yet adequate for supporting decisionmaking.'" *Id.* at 11-12 (citing National Research Council, Department of Homeland Security Bioterrorism Risk Assessment (National Academy Press, 2008)).

B. Unpredictability Affects Prices and Availability

Because terrorism is so unpredictable and could lead to such catastrophic losses, insurers have difficulty in determining an appropriate price for the coverage and the amount of capital reserves that should be maintained for the risk.[32] The Federal backstop limits insurers' risk to the individual insurers' deductibles (collectively about $36 billion) and the 15% copayment, which makes insurers more willing to underwrite terrorism insurance and to charge lower prices.[33]

This benefit of TRIA is particularly acute for risks with the highest level of damages because those are the most unpredictable.[34] An insured loss of $100 billion would be one of historic proportions. It would be more than double the most significant insured loss in U.S. History, Hurricane Katrina, which caused $47.4 billion in insured property damage (2012 dollars).[35] Insurers faced with such risks may seek to exclude terrorism from coverage as uninsurable, or, if they continue to insure for terrorism risk, they will likely charge higher prices.[36] This is precisely what happened after the September 11th attacks. Because of the scope of the risk turned out to be much greater than had previously been expected, reinsurers withdrew from the market and primary insurers sought, and obtained, approval from state regulators to exclude terrorism from coverage.[37] With the Federal backstop, however, prices have dropped to a level that most insureds are willing to pay. The "take-up" rate for terrorism insurance is relatively stable at about 60%.[38]

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[32] *See* Whitepaper at 4; *see also* WHARTON, *supra* note 16, Chapter 3.2.

[33] *See* Whitepaper at 4; *see also* Hartwig, *supra* note 22, at 11. The historical experience when TRIA was adopted supports this analysis. Insurers re-entered the market, prices dropped, and take-up rates went up. *See* RAND I, *supra* note 25, at 7.

[34] *See* Rand II, *supra* note 12, at 14 ("the expected maximum losses from unconventional attacks—the types of attacks for which modeling capabilities are not valid and reliable—are likely to exceed this [$27.5 billion Industry Aggregate Retention] threshold.")

[35] *See* Rand II, *supra* note 21, at 1, Table 1 (citing Property Claim Services, http://www.iii.org/facts_statistics/catastrophes-us.html).

[36] *See* Erwann O. Michel-Kerjan, TRIA at Ten Years: The Future of Terrorism Risk Insurance Program at 7 (Sept. 11, 2012) (written testimony presented to the U.S. House Committee on Financial Services, Subcommittee on Insurance, Housing and Community Opportunity) (available at http://opim.wharton.upenn.edu/risk/library/2012-09-11_TRIA-testimony_MichelKerjan.pdf)(last visited March 13, 2014).

[37] *See* Whitepaper at 1 & nn. 4-5; *see also* Rand II, *supra* note 21, at 18 ("In the aftermath of the attacks, private reinsurers who had underwritten the largest portion of insured losses at the World Trade Center ceased to reinsure terrorism risk in the United States, and by February 2002 commercial exclusions for terrorism were approved for use in 45 states."); Michel-Kerjan, *supra* note 30, at 4.

[38] *See* RAND II, *supra* note 21, at 18. Webel, *supra* note 13, at 11 (citing Marsh, Inc., 2013 Terrorism Risk Insurance Report at 12 (May 2013); Michel-Kerjan, *supra* note 30, at 5. It is worth noting, however, that a take-up rate of 60% means that 40% of insureds are not purchasing terrorism insurance so that in the event of a terrorism loss, those insureds will not have coverage. *See id.* Virtually 100% of the losses from the September 11th attacks were covered by insurance because terrorism was not excluded. *Id*.

C. Non-Renewal of TRIA will Increase Prices for Terrorism Insurance and Reduce Availability

Both the current unpredictability and the historical experience with terrorism insurance coverage suggest that if TRIA is not renewed, the cost for terrorism insurance will go up and the availability (or "take-up" rates) will go down.[39] Even now, some nine months prior to expiration, some insurers have started excluding terrorism losses on renewal policies with terms that extend into 2015.[40]

III. Other Countries Facing Terrorism Risk have Government Programs for Terrorism Insurance

A. Many Countries Have Adopted Government Programs for Terrorism Insurance

In addition to the United States, at least ten other countries have significant government programs for terrorism insurance.[41] Many of these programs were set up following the September 11th attacks, [42]

[39] *See* RAND II, *supra* note 21, at 18-19 (noting that "industry experts project significant contraction of the amount of terrorism insurance offered if TRIA were not to be renewed"); Hartwig, *supra* note 27, at 11 (noting that "Aon estimates that 70% to 80% of the market would encounter terrorism exclusions if the program were discontinued"); Rodd Zolkos, *Risk Managers Fear Insurance Gaps if TRIA is Allowed to Lapse: Survey*, Business Insurance (Oct. 29, 2013) (44.9% of risk professionals reported that allowing the Federal backstop to expire would decrease their terrorism coverage limits and 23.8% report that they think terrorism coverage would not be available without the Federal backstop); Marsh Risk Management Research, Market Update, 2013 Terrorism Risk Insurance Report at 19 (May 2013) (projecting that because of finite capacity of the stand-alone terrorism market, the cost of terrorism insurance could be five to ten times higher than under the Federally-backed terrorism program, and that capacity in some areas could be so limited that only 10% of the current Federally- backed terrorism insurance would be available in the stand-alone market) (available at http://www.insureagainstterrorism.org/MMC%20TRIA%20Report%2004-2013.pdf) (last visitied March 24, 2014). (http://www.businessinsurance.com/article/20131029/NEWS06/131029801?tags=|59|306|338|76|339|313|340|302|83|88) (last visited March 13, 2014).

[40] *See*, *e.g.*, Arthur D. Postal, *Market is Already Reacting to Possible Inaction on TRIA, Industry Rep Says*, PropertyCasualty 360 (February 25, 2014) (http://www.propertycasualty360.com/2014/02/25/market-is-already-reacting-to-possible-inaction-on#.Uw0OBAqoUn4.email)(last visited March 13, 2014); Brian J. Green, *The Future of TRIA*, Risk Management Magazine (February 20, 2014) ("Insurers have issued, and are continuing to issue, policies that extend beyond the program's expiration at the end of the year. They are also including conditional language for the post-Dec. 31 period in which TRIA may not exist, or may not exist on its current terms. But some insurers are not offering post-Dec. 31 terrorism coverage at all.") (available at http://www.rmmagazine.com/2014/02/20/the-future-of-tria/) (last visited March 25, 2014); *Unease Over Terror Insurance Rattles Market*, Commercial Mortgage Alert (November 1, 2013) ("Zurich North America told insurance brokers and consultants this week that starting in January, policyholders will be notified that their terrorism coverage could be altered, or premiums increased, if the government program lapses. A recent memo from Liberty Mutual was more direct, saying if the program isn't renewed, it will end coverage for certain terrorist acts. ") (available at http://www.cmalert.com/headlines.php?hid=182897) (last visited March 25, 2014); *Prepared Remarks of Ethan Sonnichsen, National Association of Insurance Commissioners, Financial Services Panel Series: "The Reauthorization of the Terrorism Risk Insurance Act: A Panel Discussion"*, National Association of Insurance Commissioners & The Center for Insurance Policy and Research (" Indeed, insurance regulators around the country are already being asked to review policy exclusions for 2014 contracts that dramatically reduce coverage if TRIA is not reauthorized.")(http://www.naic.org/documents/government_relations_tria_reauth_panel_discussion.pdf),

[41] *See* airmic Technical, Terrorism Insurance Review at 5 (2013) (Australia, Belgium, France, Germany, Israel, Netherlands, Northern Ireland, South Africa, Spain, United Kingdom, United States).

although some programs pre-date September 11, 2001, such as the program in the U.K., which was started in 1992 in response to I.R.A. bombings in London,[43] the program in Israel that was started in 1961 to provide compensation for war and terrorism-related losses,[44] and the program in Spain started in 1954 to cover a variety of extraordinary risks, including terrorism.[45] Although terms and conditions vary considerably,[46] nearly all of these programs operate as reinsurance[47] with some form of government involvement,[48] often with the government acting as a guarantor of the fund.[49]

B. The U.S. Approach is the Most Market-Oriented of the Major Government Programs

Although the U.S. government also acts as a guarantor of the terrorism program in this country, the U.S. approach makes greater use of market mechanisms than the approaches taken by other developed countries facing substantial terrorism risk. As explained above, the relatively high insurance industry retentions (10% of directed earned premiums as a deductible and 15% copayments) create an incentive for the development of private terrorism reinsurance. Because the programs in other countries are meant to provide reinsurance rather than to create a backstop with a space underneath for a private reinsurance market, the insurer retentions are much lower. In the U.K., for example, the industry retention is £ 100 million (approximately US$ 166 million) per event, £ 200 million (US$ 332 million) per year, with an individual insurer bearing a portion of that industry retention according to its level of participation in the pool.[50] In France, the industry retention is € 400 million (US$ 556 million) shared between 105 members of the pool in proportion to the amount of ceded business.[51] While this is higher than the retention in the U.K., on an average the retention is only about € 4 million (US$ 5.56 million) per insurer. In Australia, the industry retention is only AD$ 10 million (US$ 9.12 million), with each

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[42] *Id*. at 6.
[43] *See* Michel-Kerjan, *supra* note 36, at 9; *see also* Webel, *supra* note 4, at 8.
[44] *See* Michel-Kerjan, *supra* note 36, at 8.
[45] *See id*.; *see also* Webel, *supra* note 4, at 8.
[46] For a comparison of the terms and conditions of various governmental programs, *see generally* airmic Technical, *supra* note 41. *See also* Willis, International Alert, Terrorism Coverage in Key Countries (Sept. 2012) (available at http://www.willis.com/documents/publications/Services/International/2012/Intl_Terrorism_Alert_0912_v2.pdf); Terrorism coverage schemes – A comparative table (available at http://www.ccrif.org/partnerships/WFCP/Sessions/Day2/Alfonso_Najera_Terrorism_Handout_WFCP_Meeting_Oct_2011.pdf).
[47] *See* airmic Technical, *supra* note 41, at 9.
[48] The government is involved in nine out of ten of the most significant programs. *See id*. at Appendix A, 17-36. The one exception is Austria, but it should be noted that the limits of the Austrian pool are € 100 million, which is nearly 1/1000th of the coverage afforded by TRIA and represents an amount that in the U.S. is born by the insurance industry, not the government, because for TRIA to apply, losses must exceed $100 million, *see* 15 U.S.C. § 6701, Terrorism Insurance Program § 103(e)(1)(B)(ii).
[49] *See* Webel, *supra* note 4, at 8-9 (Spain's program is a government-owned reinsurer, U.K. and Germany have a private reinsurers established by the government with government backing); *see generally* airmic Technical, *supra* note 41, Appendix A, at 17-36 (providing details on ten countries' approach to terrorism risk).
[50] *See* Michel-Kerjan, *supra* note 36, at 10.
[51] *Id*. at 9.

insurer retaining the lesser of AD$1 million (US$ 912,000) or 4% of their gross property revenue.[52] With such low industry retentions (and in the case of France, with mandatory terrorism coverage), there is no space in the market for private reinsurers to operate.

In some countries, the terrorism program is even more intrusive on the private market. In Israel, which has had a program since 1961, the program is a government compensation system that operates like primary insurance.[53] Although not a government program per se, in Germany the government founded a private insurance company, Extremus AG, which provided € 450 billion of terrorism coverage to more than 1000 firms.[54] This company is completely reinsured, with the first € 2 billion layer provided by private companies and the next € 8 billion reinsured by the German government.[55] Spain also offers what amounts to primary insurance that covers terrorism risk, but does so through a government-managed fund[56] that is sold by insurance producers as an add-on to property insurance.[57] The Spanish program was developed initially to provide compensation to victims of the Spanish Civil War (1936-1939).[58] It provides coverage for a number of extraordinary risks that the private market will not cover.[59] Because these programs operate at the primary insurance level and have government backing, they displace private insurance at both the primary and reinsurance level.

C. Other Countries' Experience with Terrorism Risk Shows Government Involvement is Necessary

Amongst developed countries, Austria is the only country in which a terrorism pool has developed without government sponsorship and backing,[60] but this pool provides such limited coverage that it shows that the private market is not a meaningful alternative to a government-sponsored program. The amount of coverage available through the Austrian pool is only € 5 million (US$ 6.96 million) per policy per location with a maximum of € 200 million (US$ 278 million).[61] This shows the unwillingness of insurers, even in a large pool, to take on terrorism risk at catastrophic levels. The amount of coverage available in Austria is less than 1% of the estimated amount of the insurance industry retention under the U.S. terrorism program,[62] and is just barely more than 1% of insured property losses from the September 11th attacks.[63]

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52 *See* airmic Technical, *supra* note 41, at 18.
53 *See* Michel-Kerjan, *supra* note 36, at 8.
54 *See id*. at 10.
55 *Id*.
56 *See* airmic Technical, *supra* note 41, at 31.
57 *See* Michel-Kerjan, *supra* note 36, at 8.
58 *See* airmic Technical, *supra* note 41, at 31.
59 *See* Michel-Kerjan, *supra* note 36, at 8; airmic Technical, *supra* note 41, at 31.
60 *See* airmic Technical, *supra* note 41, at 19-20.
61 *See id*.
62 Using NAIC data on insurance industry direct earned premiums, the Congressional Research Service estimated that, in the aggregate, the 20% directed earned premium insurer retention under the terrorism insurance program

IV. Objections do not Justify Non-Renewal of the Terrorism Insurance Program

A. The Program is Necessary

Some people object to the renewal of the program on the ground it is no longer necessary because of developments in the terrorism insurance market.[64] However, as indicated above, the market for terrorism has developed ***underneath*** the Federal backstop.[65] The industry retention and insurer deductibles created an incentive for the market to develop, but without the backstop insurers would not have been willing to take on high levels of terrorism risk. Thus, the backstop, as a government-supported pool to cover the most catastrophic losses, facilitated the development of the market for terrorism insurance. If the program is not renewed, the insurance industry will be unwilling to continue to cover terrorism risk at current levels.[66] Insurers left the market in 2001 after the September 11th attacks,[67] in 2006 when there was a possibility of non-renewal,[68] and are in the process of leaving the market now if the program is not renewed.[69]

The necessity of government involvement is also demonstrated by the experience of other countries facing terrorism risk. Only those countries with significant government involvement have robust terrorism coverage.[70] In Austria, the only country with an industry-sponsored program ***without*** government involvement, coverage is limited to € 200 million, only about 1% of the covered property losses from the September 11th attacks.[71]

B. The Cost of the Program is Modest & Reasonable

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was equivalent to about $36 billion. *See* Webel, *supra* note 4, at 5. If 278 million (Austrian pool's maximum) is divided by 36 billion, it comes to 0.00772, or 0.772%.

63 The RAND II study notes that the insured property losses from the September 11th attacks were $23.9 billion, *see* RAND II, *supra* note 21, at 1 (this does not include non-property losses, which pushed the total to more than $32 billion). If 278 million (Austrian pool's maximum) is divided by 23.9 billion, it comes to 0.01163, or 1.163%.

64 *See*, *e.g.*, David C. John, *TRIA: Time to End the Program*, Testimony before the Subcommittee on Insurance, Housing and Community Opportunity, Committee on Financial Services, U.S. House of Representatives (September 11, 2012) (available at http://www.heritage.org/research/testimony/2012/09/terrorism-risk-insurance-act-time-to-end-the-program) (last visited March 22, 2014).

65 *See supra* § I.E.

66 An economic analysis conducted by Paul Raschky and Erwann O. Michel-Kerjan from the Wharton School Center for Risk Management and Decision Processes showed that under the current program insurers are much less diversified for terrorism risk than other kinds of coverage, which shows that insurers have provided much more capacity to the terrorism market than would have without the Federal backstop. *See* Michel-Kerjan, *supra* note 36, at 6.

67 *See* Whitepaper, *supra* note 1, at 1; Wedel, *supra* note 4, at 9-10.

68 *See* Whitepaper, *supra* note 1, at 2-3 nn. 13-14 (citing survey data).

69 *See supra* note 40.

70 *See supra* §III.A

71 *See supra* nn. 61-63 and accompanying text.

Another objection to the current terrorism insurance program is its cost. Although the Congressional Budget Office estimated that extending the terrorism insurance program would "increase direct spending by $3.1 billion over the 2008-2012 period and by $6.6 billion over the 2008-2017 period [with an] . . . additional $1.1 billion" to be spend after 2017,[72] these figures assumed that the program would pay out on average about $2.3 billion annually.[73] In fact, there have been no payments made under the Federal terrorism insurance program since its inception in 2002.[74] Thus, the actual costs under the program have been negligible.

A related criticism is that the Federal backstop is provided "for free." Those covered by the program receive the benefit of the backstop without paying for it, and therefore some characterize this as a kind of government subsidy. The CBO estimated that the value of this benefit, using insurance principles, would be approximately $1.1 billion per year.[75] One option would be to charge some kind of "premium" for participation in the program, which would be consistent with the approach taken in other countries. In the U.K., for instance, insurers pay the pool pay 0.03% or 0.006% of their property premiums depending on the location of the property,[76] resulting in current reserves of approximately £4.7 billion (US$7.79 billion).[77] On the one hand, it may be prudent to create reserves for a terrorist incident, but on the other, those reserves would take capital away from other potentially more productive uses. Moreover, the collection of premiums and maintaining reserves would be an even greater market intrusion than the Federal backstop. It would require underwriting decisions about the price of reinsurance through the program, which would be extremely difficult to do accurately because of the absence of the unpredictability of terrorism, and which would displace private market forces.

Instead of setting the price for participation in the program at the front-end, the Federal backstop uses the recoupment mechanism to set the "price" for benefits of the pooling mechanism after a terrorist event. Depending on the circumstances, the Secretary of Treasury may be required to impose up to a 3% premium surcharge on property and casualty insurance, or may have discretionary authority to determine the particulars of the surcharge.[78] This approach has the substantial benefit of pricing the cost of the program based on its actual expenditures rather than trying to predict the costs in advance. For those years that there are no certified terrorist incidents (e.g. 2001 until the present), the cost of the

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[72] Congressional Budget Office Cost Estimate, Terrorism Risk Insurance Program Reauthorization Act of 2007 at 1 (October 29, 2007) (available at http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/87xx/doc8761/triasenate.pdf) (last visited March 24, 2014).
[73] *Id*. at 6.
[74] American Academy of Actuaries, Statement to President's Working Group on Financial Markets: Terrorism Risk Insurance Analysis at 4 (available at http://actuary.org/files/Terrorism_Risk_Insurance_Subcommittee_Comments_to_Treasury_on_TRIA_9.16.13_0.pdf) (last visited March 24, 2014).
[75] Congressional Budget Office Cost Estimate, *supra* note 71, at 7.
[76] *See* airmic Technical, *supra* note 41, at 34.
[77] *See* Michel-Kerjan, *supra* note 36, at 10.
[78] *See supra* §I.D.

program is minimal. For those years in which there is a terrorism incident, the government may recover some or all of its costs, or in some scenarios, recover even more than it spends. For example, the Congressional Research Service estimated that a terrorism incident with covered losses of $27.5 billion would require the Federal government to pay $16.4 billion, but would generate $21.8 billion in recoupment, for an excess of $5.4 billion.[79]

Of course, not all scenarios would generate an excess for the government. In the event of a terrorism incident that causes $100 billion in insured losses, the Congressional Research Service estimates that the Federal government's share of the losses would be $59.5 billion, of which none would be subject to mandatory recoupment.[80] The amount would be subject to discretionary recoupment, which requires the Secretary to take into account recoupment the costs to taxpayers, the economic conditions in the insurance marketplace, the affordability of commercial insurance for small and medium-sized businesses, and other facts the Secretary considers appropriate.[81] This could leave a substantial burden on taxpayers, but a terrorism event of this size would be unprecedented. Consequently, even if the terrorism insurance program was no longer available, it is likely that the Federal government would step in and provide disaster assistance.[82] If one assumes that the government would step in, the terrorism program has the benefit of encouraging insurers to participate at some level thereby reducing the Federal government's costs by some $40 billion. Moreover, through the industry retention the terrorism insurance program uses the market mechanism to encourage pre-event planning,[83] and provides some administrative capacity for claims processing.

C. The Program is not "Corporate Welfare" for Insurance Companies

Another objection to the terrorism insurance program is that it is a kind of "corporate welfare."[84] That phrase is used as a kind of *ad hominem* attack on programs that are seen as providing a government benefit for large companies. The pejorative notion of "welfare" is the use of government power for a kind of wealth-transfer from taxpayers to corporations. In this case, there is not a wealth transfer from taxpayers to insurers because insurers, in a free market, would be free to exclude terrorism coverage from their policies. While it is true that the Federal backstop provides a pooling mechanism for high levels of terrorism risk that provide sufficient protection for insurers to undertake some insurance of terrorism risk, and that the insurers receive the benefit of premiums for insurance they sell, the recoupment mechanism in the program puts the cost of the program back on insurers.

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[79] *See* Webel, *supra* note 4, at Appendix, Table A-1, at 16.
[80] *See id*.
[81] *See supra* note 14.
[82] *Cf.* Michel-Kerjan, *supra* note 36, at 7 (predicting that the President would likely declare a disaster and provide Federal assistance in the event of substantial terrorism losses that are uninsured).
[83] *See* Whitepaper, *supra* note 1, at 5-6.
[84] *See*, *e.g.*, Robert J. Rhee, *The Terrorism Risk Insurance Act: Time to End the Corporate Welfare*, Policy Analysis (Cato Institute, September 10, 2013) (available at http://www.cato.org/publications/policy-analysis/terrorism-risk-insurance-act-time-end-corporate-welfare) (last visited March 26, 2014).

Those covered by insurance receive a more direct benefit from the program than do insurers (who otherwise would just exclude terrorism risk), but insureds also would pay the premium taxes used to recoup the cost of Federal payments after a terrorist attack.

Moreover, the government is in the best position to combat terrorism through the use its intelligence services, law enforcement, and military power. All taxpayers provide financial support for these efforts and benefit from them. The Federal backstop for terrorism insurance is a reasonable extension of these efforts, especially when the private sector cannot get access to intelligence and law enforcement information about terrorism that might be used for modeling purposes.[85] Because the government has better access to the information about terrorism risk, and is in a better position than those in the private sector to reduce that risk, it is reasonable that the government should bear some of the consequences of terrorism risk.

V. Conclusion

The U.S. terrorism insurance has been successful. The Federal backstop has provided a risk pooling mechanism to address the catastrophic risks associated with some terrorist activities, while at the same time leaving insurers with enough responsibility for terrorism risk to create an incentive for a private market to develop underneath the backstop. Although the U.S. has been fortunate that it has not been subject to any major terrorist events since the September 11th attacks, the nature of terrorism risk is still highly unpredictable and potentially catastrophic. While insurers are more willing than they were to put up some of their capital to cover terrorism risk, the backstop is still essential. Without it, the catastrophic levels of risk for terrorism, combined with its unpredictability, will cause insurers to limit the amount of terrorism risk that they are willing to underwrite, which will reduce coverage and increase prices. While some assert that without the Federal backstop the market will provide sufficient terrorism insurance, these assertions appear to be based on ideological "faith" in market principles rather than any empirical evidence. The historical evidence, current actions of insurers, and the evidence from other countries shows that the market operating without any government support will provide low levels of terrorism insurance coverage, if any, at much higher cost. If the U.S. wants to maintain significant levels of insurance protection for terrorism, it should extend the terrorism insurance program.

[85] *See* Whitepaper, *supra* note 1, at 3-4.