



Terrorism Insurance Coverage

On December 22, 2005, after a lengthy debate in which both houses of Congress deliberated the federal government's role in extending the Terrorism Risk Insurance Act of 2002 (TRIA), President Bush signed the Terrorism Risk Insurance Extension Act of 2005 (Extension Act). The extension effectively continues the program until December 2007, but places further modifications on its scope.

Background and Purpose of TRIA

According to the Insurance Information Institute, in addition to the risk of natural disasters, the insurance industry faces the threat of terrorist attacks. Losses stemming from the destruction of the World Trade Center and other buildings by terrorists on September 11, 2001 totaled about \$32.5 billion, including commercial liability and group life insurance claims—not adjusted for inflation—or \$35.9 billion in 2005 dollars. About two thirds of these losses were paid for by reinsurers, companies that provide insurance for insurers.

Prior to 9/11, insurers provided terrorism coverage to their commercial insurance customers essentially free of charge because the chance of property damage from terrorist acts was considered remote. After 9/11, insurers began to assess the risk. For a while terrorism coverage was scarce. Reinsurers were unwilling to reinsure policies in urban areas perceived to be vulnerable to attack. Primary insurers filed requests with their state insurance departments for permission to exclude terrorism coverage from their commercial policies. All but five states, New York, California, Texas, Florida and Georgia, granted permission.

These five states rejected the exclusion in part because they were concerned about the definition of terrorism and the impact that such exclusions would have on small businesses in their states.

Concerned about the limited availability of terrorism coverage in high risk areas and its impact on the economy, Congress passed the Terrorism Risk Insurance Act (TRIA). The Act provides a temporary program that, in the event of major terrorist attack, allows the insurance industry and federal government to share losses according to a specific formula. TRIA was signed into law on November 26, 2002. Following passage of TRIA, the exclusions from terrorism coverage granted by the states were rescinded as the law obligated insurers to offer terrorism coverage.

Passage of the law enabled a market for terrorism insurance to begin to develop because the federal backstop effectively limits insurers' losses, greatly simplifying the underwriting process.

Background on terrorism coverage

The nature of insurance and the risk of terrorism:

To be readily insurable, risks have to have certain characteristics. From an insurance viewpoint, the characteristics of terrorism risk are very different from the kind of risks typically insured. For a risk to be readily insurable:

- The risk must be measurable. Insurers must be able to determine the possible or probable number of events (frequency) likely to result in claims and the maximum size or cost (severity) of these events. For example, insurers know from experience about how many car crashes to expect per 100,000 miles driven for any geographic area and what these crashes are likely to cost. As a result they can charge a premium equal to the risk they are assuming in issuing an auto insurance policy.
- A large number of people or businesses must be exposed to the risk of loss but only a few must actually experience one so that the premiums of those that do not file claims can fund the losses of those who do.
- Losses must be random as regards to time, location and magnitude.

Insofar as acts of terrorism are intentional, terrorism risk doesn't have these characteristics which makes it difficult to insure. There have been very few terrorist attacks, so there is little data on which to base estimates of future losses, either the frequency or severity. No one knows what the worst case scenario might be. Terrorism losses are also likely to be concentrated geographically, since terrorism is usually targeted to produce a significant economic or psychological impact. This leads to a situation known in the insurance industry as adverse selection, where only the people most at risk purchase coverage, the same people who are likely to file claims. Moreover, terrorism losses are never random. They are carefully planned and often coordinated.

The Terrorism Risk Insurance Act (TRIA) has helped insurance companies provide terrorism coverage because the federal government's involvement offers a measure of certainty as to the maximum size of losses they would have to pay.

Assessing risk: To underwrite terrorism insurance to decide whether to offer coverage and what price to charge—insurers must be able to quantify the risk of terrorism: the likelihood of an event and the amount of

damage it would cause. Increasingly, they are using sophisticated modeling tools to assess this risk. According to the modeling firm, AIR Worldwide, the way terrorism risk is measured is not much different from assessments of natural disaster risk except that the data used for terrorism are more subject to uncertainty. It is easier to project the risk of damage in a particular location from an earthquake of a given intensity or a Category 5 hurricane than a terrorist attack because insurers have had so much more experience with natural disasters than with terrorist attacks and therefore the data to incorporate into models are readily available.

One problem insurers face is the accumulation of risk. They need to know not only the likelihood and extent of damage to a particular building but also the company's accumulated risk from insuring multiple buildings within a given geographical area, including the implications of fire following a terrorist attack. In addition, workers compensation insurers face concentrations of risk from injuries to workers caused by terrorism attacks. Workers compensation policies provide coverage for loss of income and medical and rehabilitation treatment from "first dollar," that is without deductibles.

Mandated coverages/exclusions: Insurance in the United States is state-regulated. In addition to overseeing solvency, market conduct and rates, regulators can require insurers to cover certain risks. For example, on-the-job injuries caused by terrorist attacks, both domestic in origin and foreign, are covered under workers compensation laws. Workers compensation insurance is a mandatory coverage in all states but Texas. Although benefits vary from state to state, no state permits some types or causes of injury to be covered and others excluded. The only requirement is that they be incurred in the course of employment.

Considerations for businesses

Terrorism insurance provides coverage to individuals and businesses for potential losses due to acts of terrorism. Insurance losses attributable to terrorist acts under these commercial policies are insured by private insurers and reinsured or "backstopped" by the federal government pursuant to TRIA. Under TRIA, owners of commercial property, such as office buildings, factories, shopping malls and apartment buildings, must be offered the opportunity to purchase terrorism coverage.

Under what circumstances is there coverage?

For the terrorism coverage to be triggered under TRIA for commercial policies, a terrorist attack has to be declared a "certified act" by the Secretary of the Treasury. No such declaration is needed to trigger coverage under home and auto policies because there are no exclusions for terrorism.

In some states, a doctrine known as "fire following" applies. This means that in the event of a terrorist-caused explosion followed by fire, insurers could be liable to pay out losses attributable to the fire (but not the explosion) even if a commercial property owner had not purchased terrorism coverage. Insurers are now seeking to limit fire coverage resulting from a terrorist attack, because commercial policyholders that choose to reject TRIA or other terrorism coverage are effectively paying no premium for the protection offered by fire-following coverage. So far, seven states have amended their standard fire policy laws to exclude acts of terrorism.

What is not covered? There are long-standing restrictions regarding war coverage and nuclear, biological, chemical and radiological (NBCR) events in both personal and commercial insurance policies.

War-risk exclusions reflect the realization that damage from acts of war is fundamentally uninsurable. No formal declaration of war by Congress is required for the war risk exclusion to apply. Nuclear, biological, chemical and radiological attacks are another example of catastrophic events that are fundamentally uninsurable due to the nature of the risk. Under TRIA, if some NBCR exclusions are permitted by a state, an insurer does not have to make available the excluded coverage.

Exposure analysis

To help you make the best strategic business decisions, we can help you analyze your terrorism risk exposure and work with you to manage your potential risks for insured losses resulting from an act of terrorism. Contact your account professional at 312-915-2200 to learn more about your coverage options.

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Overview of changes to TRIA

TRIA helps insurance companies provide terrorism coverage because the federal government's involvement offers a measure of certainty as to the maximum size of losses insurers would have to pay. The extension of TRIA guarantees a continued federal backstop to limit an insurer's losses, but with notable changes.

- After March 2006, the 'triggering' event, or the threshold for the Act to go into effect, is raised from \$5 million to \$50 million. In 2007, the amount climbs to \$100 million.
- A company's deductible, or the amount an insurer must pay before the federal program kicks in, rises from 15 percent to 17.5 percent in 2006, and 20 percent in 2007.
- Co-payments, the amount insurers must pay above their individual deductibles or retentions, will stay the same in 2006 as in the original legislation – 90 percent federal/10 percent insurer, but it would rise to 85 percent/15 percent in 2007.
- The industry as a whole must cover a certain amount of the losses before federal assistance is available. This amount increases to \$25 billion in 2006 from \$15 billion in 2005 and rises again in 2007 to \$27.5 billion. The cost of these losses can be spread among all commercial policyholders through a surcharge not to exceed 3 percent a year.
- The new legislation raises individual company deductibles – the amount an insurer must pay before the federal program kicks in – from 15 percent to 17.5 percent in 2006 and 20 percent in 2007.
- The President's Working Group on Financial Markets, which includes the National Association of Insurance Commissioners, would study and report on long-term terrorism insurance affordability and availability issues including group life, which the House bill would have added as a covered line of insurance. The report is due by September 2006. Some insurance industry representatives are seeking long-term market-based legislation, which would add coverage for domestic acts of terrorism, create a reinsurance program and allow insurers to establish tax-deferred reserves for terrorism losses.