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Terrorism Insurance in the Post September 11 Marketplace

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Summary

The insured losses from the terrorist attacks of September 11 are currently estimated to total as much as $70 billion, the largest insured catastrophic loss in history. Although the insurance industry has committed, and appears able, to pay losses resulting from the attacks, it has also warned that it would not be able to absorb such major losses from terrorism in the future. The problem lies with the reinsurance industry – through which primary insurers can "lay off" or spread large risks. Reinsurers are saying that due to their inability to quantify, underwrite, or price for the escalation of terrorism risks, they will not accept them in future reinsurance contracts. Without this backup reinsurance capacity, primary insurers maintain that they have no choice but to specifically exclude terrorist coverage in all of their future commercial insurance policies. There is a contention, however, over the terms of any federal assistance. The problem is coming to a head quickly: reinsurance contracts on commercial risks are generally written on a one year basis, and 70% of those currently in existence will expire on January 1, 2002. The lack of terrorism coverage after that date could impede the ability of financial services providers to finance commercial property acquisitions and new construction projects.

As a result, Congress is considering a temporary government-industry risk sharing program until the private marketplace can adapt to provide the needed coverage. There are multiple approaches to the issue. One approach is to do nothing and wait to see how the market adapts. This report discusses possible implications for markets and the current insurance regulatory structure in the absence of any Congressional action, and will be updated as events warrant.

Prior to September 11, most property and casualty insurance policies covered the risk of losses resulting from acts of terrorism, not as a specific named risk, but within general coverage provisions interpreted broadly enough to clearly cover the risk. Primary insurers and their reinsurers had not foreseen any catastrophic terrorist events on the scale of those on September 11, and generally had not charged a separate premium for the terrorist coverage. As with so many other things, September 11 changed that practice. The insurance industry now faces losses that could reach $70 billion, making this the largest ever loss in the global insurance and reinsurance industry.

Insurers initially reacted by promptly committing to pay the losses resulting from the September 11 terrorist attacks. As to future terrorist attacks, however, the industry has made it clear that it will not be able to provide coverage without major adjustments in the terms of coverage and in underwriting standards for that coverage. Anticipating that the private marketplace could make the necessary adjustments to re-establish terrorism coverage with time, the industry has asked Congress to provide a temporary "backstop" in the form of a short-term government-industry risk sharing program. Even as Congress studies various legislative proposals to address the situation, terrorism coverage is being sharply curtailed or removed from property and casualty policies, and premiums are being dramatically increased for what is available.

The Reinsurance Problem

Primary or "retail" insurers spread the risks they assume in their policies by purchasing reinsurance contracts from reinsurers.[1] This allows the insurance industry as a whole to take on greater risks than would otherwise be possible, and provide greater protection for business and industry and the economies to which they contribute around the world. The presence of insurance for most risks allows banks to lend on the security of business property, and investors to invest on the basis of a company as a going concern, without worrying about loss of collateral or business worth in a catastrophic event.

Past terrorism events have produced large but none the less financially manageable catastrophic damages. The events of September 11, however, were closer in magnitude to major invasive acts of war than bombing, vandalism, arson, or other damages normally associated with terrorist attacks. War is generally not considered to be an "insurable risk," because of a singular lack of information about likelihood, cost, hazard avoidance, or other parameters of the risk needed for pricing insurance.[2] Recovery from war damage is, as a result, often considered a governmental function because only governments are thought able to take on the costs associated with defense against war, or rebuilding in its aftermath.

In the aftermath of September 11, the world's major reinsurers have told primary insurers that they cannot quantify, underwrite, or price terrorism risk at this juncture. Further, they do not know whether Congress will create any backstop to cover the immediate situation. As a result, they have said they will no longer reinsure losses from terrorism in future reinsurance contracts with primary insurers. Some 70% of the current annual reinsurance contracts expire on January 1, 2002; without the availability of affordable terrorism reinsurance, primary insurers say they cannot shoulder the entire risk and therefore must exclude terrorism coverage from all new policies. Thus, primary insurers have begun sending notices to their policyholders informing them that they will

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[1] The reinsurance market is a global market with leading reinsurers based in the U.S. (Berkshire Hathaway, CNA, GE), the UK (Lloyd's), Switzerland (Swiss Re), Germany (Hannover Re, Allianz, Munich Re), Italy (Generali), France (Axa), and Bermuda (ACE Ltd., Partner Re, and XL Capital)

[2] For more on insurance exclusions see CRS Report RL31166, *Insurance Exclusions Clauses and Coverage of the Events of September 11*, by Christopher A. Jennings.

not provide terrorism coverage in 2002. These communications have been either in the form of a notice of nonrenewal of the entire property and casualty policy, or the addition of a terrorism exclusion from present coverage. In either case the notices have triggered an additional problem for the primary insurers under the state insurance regulatory system.

State Regulatory Problems

Under most state insurance laws, primary insurers must file the property and casualty insurance policy forms they intend to use in a state with the state department of insurance. Some states prohibit the use of such policy forms prior to their approval, and some also require the prior approval of rates to be charged as well. Thus, the communications being sent to policyholders, as well as the terrorism exclusionary provisions that will be included in renewal policies, are now starting through the regulatory approval process of the states. The Insurance Services Office Inc. (ISO), a private firm that makes filings with the states on behalf of multiple insurers, recently announced that it has filed for terrorism exclusions in 50 states on behalf of some 200 insurers. Another such firm, the American Association of Insurance Services (AAIS), is also submitting to the states the paperwork for new policy language on optional terrorism exclusions on behalf of some 600 insurers.

State insurance regulators now reviewing these filings are faced with a new version of their usual regulatory conflict: a desire to ensure that consumers in their states remain protected against losses from terrorism, and their duty not to exacerbate the problem by forcing insurers to assume unmanageable risks and thereby increasing their risk of insolvency. The District of Columbia's insurance chief has announced that he has already decided to allow the terrorism exclusions,[3] but most states are still weighing how to resolve their dilemma. The National Association of Insurance Commissioners (NAIC), the trade association of state insurance regulators, has confirmed the receipt of terrorism exclusionary forms in the various states, but has not made any recommendation as to how its members should resolve the dilemma. Instead, the NAIC, which usually guards the state role in insurance regulation, has urged Congress to take quick federal action by passing legislation to create some type of government-industry risk sharing program to give an immediate and certain short term solution to the situation.

Rating agencies, which analyze the financial strength of insurers, have warned that should Congress fail to enact some type of federal backstop by year-end, and should state insurance regulators fail to allow terrorism exclusions on commercial insurance policies, primary insurers will find themselves in an untenable situation. They will have to choose between continuing to offer terrorism coverage without adequate reinsurance, or withdrawing completely from the commercial property and casualty insurance marketplace. Standard & Poor's has indicated that either choice would result in rating downgrades, and stated: "With each day that federal legislation is not passed, pressure mounts on commercial insurers to withdraw from lines of business that unduly expose their capital to these potentially large and unpredictable risks."[4] This "squeeze" could have serious financial consequences, as emphasized by Fitch, which reported that "without enduring solutions, the result could be the partial collapse of a well-functioning insurance

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[3] Jackie Spinner, "Insurers Ask to End Terrorism Coverage," *Washington Post*, November 16, 2001, p. E2.

[4] Report dated November 12, 2001, available at [http://www.standardandpoors.com].

system that would leave many individuals, businesses and insurance companies bearing disproportionate risks, or being forced to curtail key business activities."[5] A downgrade by ratings firms, of course, could also hamper the ability of insurance companies to raise new capital, and hamper their ability to restore normal loss reserves.

Consumer representatives have also weighed into the debate with a position that makes the decision by the state insurance regulators on whether to allow terrorism exclusions even more difficult. The Consumer Federation of America (CFA) has written to all of the state insurance regulators, urging them to disapprove the commercial property and casualty terrorism exclusions filed by the ISO and others as well as the requests for across-the-board premium increases. The CFA maintains that such exclusions and premium increases in the marketplace will make for great disruption after January 1, 2002. Instead, the CFA maintains that state regulators should review the regulatory actions taken after Hurricane Andrew, the Northridge earthquake, and the riots of the 1960s (the FAIR Plan model) that stabilized the insurance marketplace after those events.

Congressional and Legislative Activity

In this context, Congress is considering federal intervention to should insurance coverage of terrorism not be available after January 1. The "Terrorism Risk Protection Act" (H.R. 3210) was introduced November 1, 2001, and voted out of the House Financial Services Committee by a voice vote on November 7. On the floor, the bill was amended by substituting the text of H.R. 3357 in its entirety. H.R. 3210, as amended, passed the House on November 29.[6]

The basic plan in H.R. 3210 provides for a one-year government commitment to backstop private insurance against losses resulting from confirmed terrorist events. Such federal assistance could be triggered when insured losses reached $100 million, after which the government would lend the money to pay 90% of terrorism losses up to an aggregate loss maximum of $100 billion. The loan would be repaid by a series of assessments and surcharges levied upon policyholders. Three bills have been introduced in the Senate, S. 1743, S. 1744, and S. 1751. The Senate versions differ as to losses that would trigger government assistance, the extent of assistance, and whether the assistance would be in the form of loans or grants that would not have to be repaid.

In addition to the debate over whether government payments for losses would have to be repaid and the trigger amounts for such payments, there is also disagreement on

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[5] Christopher Oster, "Reports on Insurers Covering Terrorism Stress Federal Role," *Wall Street Journal*, November 14, 2001, p. A24.

[6] Support for a federal backstop is coming not only from insurers, but also from real estate and construction interests, as well as from lending institutions. In New York some 17 real estate and construction organizations recently wrote to congressional leaders saying that without such a federal backstop the ability to finance, construct, buy, or sell properties in New York and across the nation could be at risk. Bankers, whose risk profiles are closely monitored by banking regulators and the Federal Deposit Insurance Corporation, reportedly are reexamining their lending practices and are waiting to see whether terrorism coverage will be available before agreeing to finance new real estate projects and business ventures.

other issues such as whether insurers should be required to provide terrorism coverage, whether insurers should be able to accumulate tax-free reserves for terrorism losses, and whether legal reform (in particular, with respect to punitive damages against companies deemed liable for failure to prevent attacks) should be addressed.

One potential result of the enactment of any federal backstop by Congress that has not been part of the public debate is the effect such a program could have on the future of insurance regulation. Even though the business of insurance is considered interstate commerce, Congress expressly delegated its regulation to the states in 1945 with the passage of the McCarran-Ferguson Act. When the Gramm-Leach-Bliley Act (GLBA) was enacted in 1999, it reaffirmed the McCarran-Ferguson delegation and designated state regulators as the "functional regulators" of insurance in the total financial services regulatory scheme.

Over the years, there have been several attempts to get Congress to reassess its delegation of regulatory authority of the insurance business to the states. The most recent effort is that now being mounted by the trade groups of life insurers, property/casualty insurers, and banks. These groups point to the provisions of GLBA that enable affiliations between banks and insurers, and call for a system of federal chartering and regulation of insurers on an optional basis, similar to the dual regulatory system that applies to commercial banks, in order to make such affiliations easier and more practical. Insurers, they maintain, should have the option to stay under state regulation or file for a federal charter and be regulated by a federal agency. Should Congress enact a federal backstop for terrorism insurance, the program could well require a degree of regulation on a national basis and either call for specific federal regulation or greater uniformity in state regulation. This, according to some analysts, could influence discussion on the issue of state versus federal insurance regulation.

The Evolving Marketplace

As the congressional debate continues over whether to provide a temporary backstop to allow the market to adjust to the new reality of terrorism risks, there are indications of how, in the absence of such legislation, the marketplace will adjust to address the problem. Insurers and reinsurers can be expected to seek to recoup their September 11 losses, as well as to attempt to limit their future losses in any new business they write. As a result, any terrorism coverage that can be obtained would be at a substantial increase in cost. Insurance brokers report that since September 11 they have seen tenfold increases in premiums being charged by those insurers still willing to write commercial property and casualty coverages. This is especially true where the coverage is on so-called "terrorism magnets" such as chemical plants, stadiums and office towers.

On the other hand, the high premiums that are now emerging, along with the increase in demand for terrorism coverage, are already being seen as a new business opportunity by some in the marketplace: at some price, the risks become potentially profitable, if they are quantifiable. Standard and Poor's predicts that some $20 billion of new capital will flow into the global insurance market over the next six months, with the bulk going into the reinsurance market. More than one-half of that new capital will be used to fund start-up ventures. This reflects, in part, the continued reluctance among investors to invest heavily in existing insurers until they can demonstrate their post September 11 financial condition. Most of this new capital for start-ups has come from established insurers and reinsurers, which are creating separate subsidiary units to handle the terrorism risk. That way, in case of another large terrorist event, the parent companies would not fail, even if their new subsidiaries were to become insolvent.

As of November 15, Bloomberg – the financial services consulting firm – had identified some 25 insurers and reinsurers in the process of raising a total of about $20 billion through sales of stock, bonds and private equity to take advantage of surging post September 11 insurance premiums. One example is that of the large insurance brokerage firm of Marsh & McLennan (M&M): soon after September 11, M&M made plans to form a new subsidiary with $1 billion in new money to sell insurance to corporate customers at sharply higher rates. AXIS Specialty Ltd., based in Bermuda, opened for business on November 20 with a total of $1.6 billion in capital. M&M also launched a new consulting unit to capitalize on heightened corporate fears of terrorism. As of this date, however, the overall outcome remains uncertain.