Covering the Cost of Terrorism

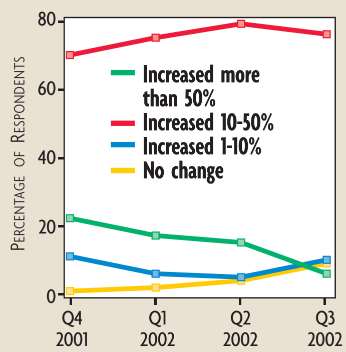
BY CHARLES GERENA

The tragic events of Sept. 11, 2001, made it frighteningly clear that the United States was vulnerable to terrorist attacks. Fear suddenly gripped the nation, including insurers faced with claims that surpassed the record $17 billion in insured losses from Hurricane Andrew in 1992. Uncertainty about future attacks led to a much-publicized shortage of terrorism coverage that rippled through the economy. In response, Congress approved a bill last November that puts Uncle Sam in the terrorism reinsurance business.

Reinsurance companies provide primary insurers with additional capital to cover extraordinary claims after a major disaster. But the Sept. 11 attacks forced reinsurers to reassess the likelihood and extent of damage from terrorists. Many firms decided to stop underwriting terrorism risks when policies came up for renewal in 2002. With fewer reinsurers willing to risk their capital, primary insurers were forced to lower their maximum payouts on terrorism-related claims, increase premiums to cover terrorist attacks separately, or exclude coverage altogether.

England faced the same problem in the 1990s. Reinsurance firms dropped or limited their terrorism coverage in response to a long string of bombings perpetrated by the Irish Republican Army. This led business interruption and building insurers to reduce their exposure to terrorism-related risks. The British government responded by creating a mutual company that provides reinsurance to its member firms. Spain, France, and Germany also have federal reinsurance programs that cover terrorism risks, while Israel has a special fund that pays for property damage triggered by politically motivated violence.

Independent Insurance Brokers and Agents Who Reported a Change in Commercial Property Premiums During the Quarter



SOURCE: Commercial Insurance Market Index surveys, The Council of Insurance Agents and Brokers

Why have governments stepped into the private marketplace to cover terrorism risks? After a major disaster, "coverage declines and prices go up because insurers don't have as much capital" to cover claims in the near term, says Anne Gron, assistant professor of management and strategy at Northwestern University. Eventually, however, rising prices "encourage capital to come into the industry" and insurers determine how to cover a similar disaster in the future.

Robert Hartwig, senior vice president and chief economist at the Insurance Information Institute, believes that it would have taken awhile for the terrorism insurance market in the United States to adjust. "And some insurers wouldn't have participated [in the market] at all," he adds.

Congress decided not to wait. The Terrorism Risk Insurance Act nullified existing exclusions of terrorist acts and required insurers to cover terrorism in a manner that "does not differ materially" from other aspects of their policies.

The bill also created a federal program that will back the insurance industry when an attack results in claims exceeding $5 million. For each claim, the program will cover 90 percent of insured losses paid to policyholders. But this coverage kicks in only after the insurer meets a deductible based on its premiums received in the previous year. In 2003, the deductible will be 7 percent of premiums collected, then it will rise to 10 percent of premiums in 2004, and 15 percent in 2005.

Lawmakers were concerned that the high costs of terrorism insurance could damage an already soft economy. In particular, they worried that, without government action, many new construction projects would be postponed or foregone.

Some insurance experts argue, though, that Congress didn't need to create a broad reinsurance program. That's because the shortage of terrorism coverage has affected mostly high-profile properties and densely populated cities. The Consumer Federation of America recently researched the availability of coverage and found that "there were very few problems, mostly centered in New York City," says J. Robert Hunter, director of insurance of the Arlington, Va., group. "The problem with New York is that all of the buildings are right up against each other. If a bombing occurs, it hits a whole bunch of places at once. Insurers were worried about concentration of risk." Chicago also had problems, but not Los Angeles since it is spread out over a larger geographical area.

Another argument against federal terrorism reinsurance is that insurers were already making progress in calculating and pricing terrorist risks. Premiums for some policies were falling and new risk models were in the works.

Finally, Hunter and others worry about the economic implications of the federal government providing reinsurance at no cost. Will the private sector be less willing to offer reinsurance because they won't want to compete? Will insurers be less likely to encourage their policyholders to reduce their terrorism risks because they won't suffer the full financial consequences?

Despite these concerns, the new program will hopefully introduce certainty into the insurance industry. "Insurers understand that in the event of a future terrorist attack they are going to sustain losses," concludes Hartwig. Now, "insurers know what their maximum possible loss is. [And] they can make sure they have adequate capital to handle the worst-case scenario." **RF**