

The dogs of war

Charles LiMandri, an international lawyer specialising in terrorist insurance risk, explains how the Terrorism Risk Insurance Act passed into law in the US last November is impacting the battered property-casualty insurance market. Although the new law helps to stabilise the market in the short-term, possibly the biggest challenge ever for the risk management industry awaits us now: not only in modelling the price, but also in managing the overall impact of terrorist risk on our economies.

The property-casualty insurance marketplace was changed in a day because of the 9/11 terrorist attacks. Terrorism coverage had previously been provided to policyholders for free because the US was considered immune to such attacks. But it is now a real and complex problem, especially now with the lingering threat of further terrorist attacks.

Economic losses in New York City are forecast to total as high as US\$97 billion, and most estimates predict that US\$40 to US\$50 billion of this is covered by insurance. Notwithstanding the paramilitary nature of the 9/11 attacks and the responsive declaration of "war on terror" by the US, insurers generally refrained from asserting the standard "act of war" exclusion found in most commercial policies. While such restraint was probably motivated by patriotism – and certainly resulted in good public relations for the insurers – it was also a practical choice.

Commentators were virtually unanimous in concluding that the general war risk exclusion would not apply to the 9/11 acts of terrorism. In light of precedential case law, it is unlikely that courts would have enforced the exclusion anyway. This is because it is only applicable in cases of: (1) internal strife in the form of an insurrection, rebellion, revolution or civil war which actually attempts to overthrow the government or (2) a conflict between two sovereign nations or *de facto* governments. As a result, the insurance industry has had to absorb the most catastrophic losses in its history.

Since 9/11 reinsurers generally have been unwilling to assume the risks of terrorism, the ability of insurers to survive catastrophic losses, such as those that acts of terror might inflict, has depended on their ability to be reimbursed for at least a part of their losses from them. Loathe to provide such coverage without reinsurance, some primary insurers have left the marketplace as a result, leaving much of the financial responsibility for future attacks on their former policyholders.

Nevertheless, while coverage has disappeared for some businesses (which also happened during the 1980s pollu-

tion coverage crisis and in the wake of Hurricane Andrew), the good news is that the market has not completely collapsed. But the bad news is that any terrorism insurance now available is only offered at almost unaffordable prices.

Specific capacity and pricing problems in insurance, like the ones currently affecting terrorist act coverage, are not uncommon and are usually self-correcting with time. Thus, if we could confidently propose that 9/11 defines the upper boundary of potential terrorist losses in the US, then we might conclude that no new response is required from the insurance industry or the government.

Indeed, catastrophic losses are not new to the insurance industry, and terrorism arguably stands as simply another kind of catastrophe – a peril not quantitatively different from various kinds of natural disasters. Hurricanes, earthquakes, volcanic eruptions, tidal waves and even asteroids all have the possibility of causing insured losses in the tens or even hundreds of billions of dollars. In theory, both terrorism and natural disaster losses could be so "mega-catastrophic" that private risk-spreading mechanisms would be rendered insignificant. In such case, government institutions would become the means of repairing damage and spreading the risk of future losses.

But there are important differences between natural catastrophes and terrorism events. Scientists can estimate the frequency of earthquakes and hurricanes based on past experience and sophisticated predictive models. In contrast, terrorism involves human-caused losses – the timing, severity and frequency of which are not subject to reliable predictability based on past events. The problem is that we cannot be certain that the upper boundary has been reached, and we are uncertain about where the mean now rests in the distribution of terrorism losses. One lesson learned from 9/11 is that the mean loss level with respect to terrorism exceeds all prior estimates, and this lack of predictability raises doubts about the capacity of the industry to cope with future attacks by terrorists.

While the financial capacity of the property-casualty

industry is finite, the potential harm that terrorists can inflict could produce practically limitless losses. And until the uncertainty surrounding the terrorism risk abates and markets stabilise, problems of cost and availability will persist. This has been true in other insurance sectors in the past, and temporary dislocations do not necessarily justify government intervention. In fact, as noted above, private markets have demonstrated admirable resiliency in the aftermath of 9/11.

But if the industry was required to face a second 9/11-type event, its weakened condition could produce a much different scenario. Moreover, there looms the possibility of a mega-catastrophe – or series of smaller events in close succession that would have the cumulative impact of a mega-catastrophe – that could still overwhelm the insurance industry. Therefore, more stability and predictability are needed in the marketplace before insurers can reasonably assess, measure and spread the risks of terrorism. All of this suggests the desirability of a role for the federal government.

One way the federal government could become involved in terrorism coverage would be to provide insurance directly, totally displacing the private markets. Another approach would be for the government to create a reinsurance company covering acts of terrorism. Yet another way would be to have the federal government share the risk along with private entities. The challenge of crafting this last aforementioned approach is to design a system that requires insurer participation in bearing an appropriate share of the risk and in compensating losses, while not placing disincentives on the private placement coverage. Why? The advantage is that such a system can be adjusted or dismantled as private markets improve their ability to underwrite terrorism coverage and manage this unfathomable risk.

The governmental risk sharing approach involves underwriting the portion of the terrorism risk that goes beyond the industry's capacity to absorb, and this kind of limited backstop would cap the industry's losses. It makes explicit what is already commonly understood: if a mega-catastrophe were to occur, the government would provide disaster assistance after the fact. By making this informal understanding explicit, the federal government could play a useful role in facilitating a market for affordable coverage. In general terms, this is actually the approach that the US Congress recently adopted in creating a federal backstop programme.

Since 9/11 the US insurance industry has been working with its government to manage the crisis. They sought to develop a transitional mechanism that could address the capacity and pricing problems related to terrorism risks. Several proposals were considered, including a "pooling" arrangement favoured by actuarial experts and modelled after programmes in the UK and Israel. Eventually, a tem-

porary federal backstop programme, mirroring the risk-sharing relationship between primary insurers and reinsurers was designed and introduced through legislation on Capitol Hill.

New legislation

On November 26, 2002, the Terrorism Risk Insurance Act of 2002 (TRIA) became into law, and as such created a federal terrorism reinsurance programme to serve as the federal backstop for insurers in the event of future terrorist attacks.

The programme will administer a system of shared public/private compensation for insured losses, resulting from acts of terrorism, in order to protect consumers and create a transitional period for private insurance markets to stabilise. Under TRIA, property and casualty insurers are required to "make available" coverage for losses resulting from certain intentional acts of terrorism, which coverage had been excluded from many policies since the terrorist attacks of 9/11.

However, subject to a premium-based deductible, the federal government will reimburse insurers for 90% of their terrorism-related losses. TRIA does not establish prices for terrorism insurance: the power to regulate premium rates remains with the state governments. TRIA is intended to serve as a temporary programme, as it is scheduled to terminate after three years – on December 31, 2005.

The following is a summary of the key provisions that comprise TRIA, as well as some observations regarding its implementation.

Defining terrorism

An "act of terrorism" under TRIA is an act certified by the Secretary of the Treasury in concurrence with the Secretary of State and the Attorney General:

- To be an act that is dangerous to human life, property or infrastructure
- To have resulted in damage within the US¹ (or outside the US in the case of US airliners or ships)
- To have been committed by an individual or individuals acting on behalf of any foreign person or foreign interest, as part of any effort to coerce the civilian population of the US or to influence the policy or affect the conduct of the US government
- To have resulted in property and casualty insurance losses in excess of US\$5 million

Acts that otherwise meet these criteria but that occur in the course of a war declared by Congress cannot be certified as acts of terrorism under TRIA.² The certification (or determination not to certify) by the Secretary of the Treasury is final and not subject to judicial review. Thus, TRIA brings into the federal backstop only that terrorism which is motivated by a foreign influence. Domestic terrorism, or terrorism losses that occur outside the US, or in the

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course of a declared war, do not fall within its scope.

Applicable insurance

TRIA applies to commercial lines of property and casualty insurance, including excess insurance, business interruption insurance, workers' compensation insurance and surety insurance. It does not apply to crop insurance, livestock insurance, private mortgage insurance, financial guaranty insurance issued by monoline financial guaranty insurers, medical malpractice insurance, health or life insurance (including group life insurance), flood insurance provided under the National Flood Insurance Act or reinsurance.

It is worth noting that TRIA authorises the Treasury Secretary to extend coverage to additional captive insurance companies, as well as to self-insurance arrangements, such as workers compensation self-insurance programmes and state workers compensation reinsurance pools and group life insurers. However, of course, any such determination must have been made prior to an applicable act of terrorism.

If a foreign or alien insurer is not on the NAIC Quarterly listing of Alien Insurers, it also is probably not subject to TRIA. As the Treasury Department will not compel its participation in the TRIA programme, many such carriers operating in Bermuda, Europe and elsewhere are electing to interpret the law as not being applicable to their business.

Mandatory availability

Between November 26, 2002 and December 31, 2004, every property and casualty insurer must "make available" terrorism coverage in all of its insurance policies (existing and new), in amounts and on conditions that do not differ materially from those offered by that insurer for other types of risks. Prior to September 1, 2004, the Secretary of the Treasury will determine whether this requirement should be extended through December 31, 2005.

TRIA nullifies any terrorism exclusions in existing commercial property and casualty policies (in other words, virtually all the standard forms in place as of the date of enactment) to the extent such exclusions preclude coverage for losses resulting from "acts of terrorism" as defined in the Act.³ Likewise, state regulatory approval of such terrorism exclusions is voided by TRIA to the extent the approved exclusions eliminate coverage as mandated under TRIA. These provisions of TRIA leave untouched those elements

of existing terrorism exclusions that deal with terrorist activity outside the scope of the federal programme, e.g. acts of domestic terrorism, or terrorism losses that do not reach the US\$5 million threshold.

An insurer may reinstate a terrorism exclusion that was in effect on November 26, 2002 if the insurer obtains written authorisation to do so from the insured or the insured fails to pay any increased premium for the terrorism coverage after 30 days' notice. Thus, an insured may elect to pay an additional premium for the terrorism coverage or to reinstate the terrorism exclusion for the remainder of the policy period.

Primary and excess insurers are required to offer the protection at full policy limits and can only exclude or sub-limit the coverage at the pleasure of the insured. In practice, many carriers plan to continue exclusions, sub-limits, and special deductibles for "non-certified" events and offer full limits for "certified" events at a given premium. In addition to their full limit TRIA pricing, the initial Treasury Guidance indicated that insurers can request, and can offer sub-limited terrorism coverage provided that (1) the insurer first makes an offer for full coverage; and (2) state regulations allow sub-limiting of the coverage.

TRIA does not regulate premium rates. Each state retains the authority to regulate both premium rates and policy forms (but it may not deviate from TRIA's definition of an "act of terrorism"). Any state may invalidate a rate if it is found to be excessive, inadequate or unfairly discriminatory. In order for insurers to meet TRIA's requirement for immediate implementation, any state law providing for prior approval of rates or forms (or time delays in implementing a rate or form) is not applicable during the first year of the programme.

It is still too early to state definitively what trends are emerging from insurers with respect to the pricing of terrorism coverage mandated by TRIA. So far, many insurers seem to be taking a "surcharge" approach (i.e. a percentage of the property insurance premium) in most cases. Early indications show a wide variety of pricing surcharges ranging from as little as 2% to as much as 100% of a policy's premium. Undoubtedly, this early disparity in pricing reflects a wide range in underwriters' affinity for this risk.

Under TRIA, pricing eventually will be subject to state regulatory review and insurers will need to provide state regulators with information to support their pricing.



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LiMandri: Greater urgency for pricing models

Insurers will likely arrive at pricing by assessing the severity profile of each insured's risk, the cost of reinsurance to protect their retention under TRIA, and the cost of capital relating to their net retained line.

Share of losses

With respect to coverage offered in compliance with TRIA, insurers will receive reimbursement from the federal government for a portion of paid losses. Specifically, the federal government will reimburse an insurer for 90% of all terrorism-related property-casualty losses that exceed the applicable insurer's deductible. Each insurer's deductible will be calculated by comparing that insurer's covered losses in that year to its direct earned premiums for lines of business covered by the programme in the prior year. The amount of the insurer's deductible scales upward each year in the programme.

In addition to the deductibles, insurers will be responsible for paying 10% of the remaining certified terrorism losses until aggregate insured losses for the programme year reach US\$100 billion. Without further authorisation by Congress, the federal government's payment responsibility for insured losses cannot exceed that US\$100 billion cap in any one year. At that point, no further federal reimbursements will be made under TRIA, and assuming an individual insurer has met its deductible, it will not be liable for any further payment with respect to terrorism-related losses.

In any programme year for which certified terrorism losses exceed US\$100 billion, the responsibility for devising a plan to address further terrorism losses falls on Congress. Any determinations made by the Secretary of the Treasury with respect to the allocation of losses between an insurer and the federal government are final and not subject to judicial review. The federal government's portion of insured losses will be reduced by the amount of compensation otherwise provided by the federal government to any person in connection with such losses.

Early indications show that the financial community is worried about the government's mandate that insurers get back into the pool of terror risk. The chief concerns are:

- The untested underwriting pricing models they will necessarily use for this risk
- Whether the government reinsurance may tempt insurers to undercut one another's pricing
- The degree to which the deductibles pose a threat to insurers' financial viability

While insurer deductibles under TRIA are calculated as a percentage of gross premiums, insurers that rely heavily on reinsurance base their capital levels on net premiums, which is a much smaller number. This means their liability under TRIA could represent a large proportion of their capital. It is reasonable to anticipate that insurers' concerns regarding their financial ratings may have a significant impact on the pricing they propose for TRIA coverage and may influence them to reduce their overall net capacity offerings in order to limit their TRIA exposure.

Recoupment and policy surcharges

TRIA allows the federal government to recover a portion of any payments it makes under the programme through policy surcharges. Payment recovery is mandated for any gap between the total amount of insurer loss payments (i.e. the percentage-of-earned-premium deductibles plus the 10% insurer participation share) and a specified dollar amount referred to as the "insurance marketplace aggregate retention amount." Put simply, this aggregate retention is the maximum dollar amount that all insurers participating in the programme will be liable to pay out for certified terrorism losses in a given programme year. When the total of insurer deductibles and percentage participation does not equal this aggregate retention, insurers will have to pay the difference back to the government. The industry aggregate loss figures used to determine whether or not there will be surcharges are:

- US\$10.0 billion in year 1
(the balance of 2002 and 2003)
- US\$12.5 billion in year 2 (2004)
- US\$15.0 billion in year 3 (2005)

For any programme year in which insurer deductibles and percentage participation amounts equal or exceed the speci-

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fied aggregate retention, payment recoupment is at the discretion of the Secretary of the Treasury. That decision will be based on the Secretary's judgement concerning a number of industry factors, including the cost of the federal programme to the taxpayers and the financial condition of the insurance industry.

Payment recovery will be achieved by means of a premium surcharge on property and casualty insurance policies that are in force after the date the recoupment amount is established by the Treasury Secretary. However, regardless of the statutorily defined recoupment amount, no surcharge may exceed 3% of the premium under any policy. All surcharges would be collected from policyholders by insurers and remitted to the Treasury.

Reinsurance

Insurers are free to obtain commercial reinsurance coverage for their remaining terrorism exposure, i.e. for the deductible and their 10% share. To the extent that the proceeds of commercial reinsurance – combined with recoveries under TRIA – exceed the aggregate amount of an insurer's terrorism-related losses, the excess must be returned to the Treasury unless the reinsurance agreement provides otherwise. As stated above, a reinsurer's obligations for terrorism-related losses under a reinsurance policy are not covered under TRIA.

Because TRIA excludes reinsurers from coverage, it must be assumed for now that some carriers positioned as reinsurers will retain their terrorism exclusions. It may be advantageous for some insurers to obtain the terrorism reinsurance provided by the government, particularly since the deductible in TRIA is defined as a percentage of the insurers' direct earned premiums in the previous year. This arrangement could also serve to ease overall programme administration by avoiding issues of complex plans with multiple reinsurers. Still, other insurers may prefer to modify their programme structure to have access to risk transfer through a free-standing terrorism policy.

Notification to policyholders

In order to be eligible for reimbursement, the insurer must provide "clear and conspicuous disclosure" to the policyholder of the premium to be charged for terrorism coverage and the federal share of compensation for any losses. The disclosure must be given on a separate line item in the policy at the time of offer, purchase and renewal. Details

concerning the form of disclosure will likely be set forth in regulations being developed by the Treasury Department. Interim rules were released on February 25, and published in the Federal Register on February 28 at 31 CFR Part 50.

Exclusive federal jurisdiction

TRIA creates an exclusive federal cause of action for property damage, personal injury or death arising out of or resulting from an act of terrorism. All causes of action that are otherwise available under state law are pre-empted. The substantive law to be applied by the federal court will be derived from the law of the state in which the terrorism occurred. Although TRIA does not prohibit an award of punitive damages in litigation arising out of acts of terrorism, no punitive damages will be paid by the federal government under TRIA. In other words, punitive damages will not count as insured losses subject to government reimbursement.

Enforcement

The Secretary of the Treasury will oversee the programme. Thus, the Treasury Department is responsible for promulgating regulations implementing TRIA, as well as administering and enforcing the programme. The Secretary may impose civil monetary penalties up to US\$1 million for each instance of failing to pay assessments or surcharges, submitting erroneous data or any other violation of the implementing regulations.

Conclusion

Although the Terrorism Risk Insurance Act of 2002 provides a three-year time bridge for the insurance marketplace to adapt to the new world of terrorism, it does not ultimately spare insurers, policyholders and the US economy from the economic costs of terrorism. While TRIA should provide some stability to the insurance marketplace, it is not a panacea. The risks associated with trying to underwrite terrorism have not changed, and that reality still hangs over the insurance industry even with the involvement of the federal government.

Although TRIA provides a federal reinsurance mechanism, the complex questions of how to assess and price coverage for terrorism losses remain. This is where risk management will need to meet new challenges. As with all exposures, the issues of frequency and severity, as well as mitigation, will likely govern the pricing models and deci-

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sions of underwriters concerning TRIA coverage. Therefore, insurers will likely seek data that reflects concentrations of risks (property and people) in areas that are most likely prone to such attacks. It would also behoove insureds to make certain that their disaster recovery plans are up to date and prominent in the exposure data supplied to underwriters. In any event, the immense unpredictability of terrorism risks means that premiums will remain difficult to determine, at least until insurance company actuaries and scientific modelling are better able to gauge potential losses.

Additionally, TRIA's impact on Directors and Officers liability coverage must be considered. With the recent advent of terrorism exclusions in D&O policies, the insurance industry has distanced itself from shareholder suits that might assert negligence on the part of corporate governors for not protecting property from losses related to terrorist events. This risk, and the "failure to purchase insurance" exposure of boards of directors, are among the issues that corporate insurers need to consider before they elect to decline the TRIA-mandated coverage.

Finally, the logistical, capacity and pricing challenges involved with trying to cover the inherently unpredictable risks of terrorism will undoubtedly remain with us as long as the threat of terrorism exists. ■

Notes

1. In addition to each of the fifty states, the "US" includes: the District of Columbia, Puerto Rico, the Northern Mariana Islands, American Samoa, Guam, the US Virgin Islands, any territory or possession of the US, and the territorial sea and continental shelf of the US, as well as any US mission (embassy or consulate).
2. Unlike other lines of coverage, workers' compensation losses resulting from acts of war are covered by the programme.
3. ISO and AAIS, the two major insurance policy-drafting and statistical bureaus, are moving quickly to file new endorsements that address terrorism risks not included in the federal programme. They have already filed certain endorsements for use with policies currently subject to a terrorism exclusion, including:

- a) Endorsements that modify existing terrorism exclusions to bring them into compliance with TRIA – i.e., specifying that the exclusions do not apply to a "certified act of terrorism";
- b) Endorsements that remove existing terrorism exclusions altogether, – reiterating the statutory limits on the insurer's obligation to pay losses in connection with a "certified act of terrorism," with noncertified acts of terrorism covered on the same basis as any other insured property loss;
- c) Endorsements that merely impose the statutory cap on "certified acts of terrorism" losses – for use with mid-term policies which have no terrorism exclusion attached; and
- d) Endorsements that exclude "certified acts of terrorism" losses altogether or, in those states requiring property coverage for certain fire losses with an exception for other such losses – these may be used only if the insured has rejected federal coverage in writing or has failed to pay the terrorism premium within 30 days of notification.

These filings have been made under a provision of TRIA that exempts them from individual states' prior approval laws; thus, the endorsements are available for use immediately.

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