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Terrorism Insurance - The 2002 Marketplace

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Summary

The terrorist attacks of September 11 resulted in the largest insured catastrophic loss in history, estimated to total as much as $70 billion. Even though the insurance industry committed to pay losses resulting from the attacks, industry spokesmen asserted that in view of the impending unavailability of terrorism reinsurance on January 1, 2002, primary insurers would not be able to cover future terrorism losses on renewals of commercial risk policies without a federal backstop.

In the 107th Congress, first session, the House of Representatives passed H.R. 3210 on November 29, 2001, providing for a temporary federal backstop. In the Senate, four similar measures were introduced (S. 1743, S. 1744, S. 1748, and S. 1751), but no action was taken. Senate Majority Leader Tom Daschle indicated that backstop legislation would be considered again in 2002, and on June 7, 2002, Senators Dodd, Sarbanes, Schumer, and Reid introduced S. 2600, the Terrorism risk Insurance Act. Meanwhile, there are indications that the insurance marketplace has made strides toward resolving a major part of the terrorism coverage issue and federal legislation may be less likely to have its originally intended impact. However, recently the Joint Economic Committee found that the market for terrorism insurance remains limited, and that the problems associated with terrorism insurance pose a significant threat to sustained economic growth. This report looks at the terrorism insurance marketplace in 2002 in the absence of federal legislation, the economic outlook for the insurance industry, and the regulatory responses of state insurance officials. This report will be updated as events warrant.

After the terrorist attacks of September 11 (9/11), the market for terrorism risk insurance changed substantially. Previously, most property and casualty insurance policies covered the risk, not as a specific named risk, but within general coverage provisions, and usually at no separately stated premium. With insured losses from 9/11 now estimated to total as much as $70 billion, making it the largest insured catastrophic loss in history, insurers have indicated that even though they would pay the claims on the 9/11 occurrence, they would not do so for future such events.[1] Reinsurers have told

[1] For additional information on the impact of September 11 on the marketplace, see CRS Report (continued...)

primary insurers[2] that they will not reinsure future terrorism risks; this has resulted in primary insurers saying that they would not be able to issue policies to the public covering terrorism in the absence of such reinsurance or a specific exclusion of the terrorism risk.[3] Since some 70% of the annual reinsurance contracts in force on 9/11 were to expire on January 1, 2002, a major effort was undertaken by the insurance industry and other business interests to get Congress to pass a bill creating a temporary backstop that would assure the availability of terrorism insurance until the market could have sufficient time to adjust to the problem and devise a market based solution.

Congressional Activities

In recognition of the potential economic disruption from a lack of terrorism risk insurance, the 107th Congress, first session, considered several measures which called for a temporary federal backstop. On November 29, 2001, the House of Representatives passed H.R. 3210, providing for a one-year government commitment to backstop private insurers against losses resulting from confirmed terrorist events. Any assistance would be in the form of loans to be repaid subsequently by insurers through a series of assessments and surcharges levied upon policyholders. Four bills were introduced in the Senate (S. 1743, S. 1744, S. 1748, and S. 1751), but none passed before the Senate adjourned on December 20. Efforts to agree on a proposed compromise during 2001 also failed.

Senate Majority Leader Tom Daschle indicated that the Senate would readdress the terrorism insurance issue in 2002. Senator Daschle stated that the Senate would keep a watchful eye on the insurance market and would take the appropriate action in 2002 to respond to any problems that might arise if the Senate did not pass legislation addressing the terrorism insurance issue. During the early part of 2002, Senate efforts to reach a unanimous consent (UC) agreement to bring H.R. 3210 to the floor of the Senate and amend it by substituting the language of a compromise proposal, the Terrorism Risk Insurance Act, were unsuccessful. On June 7, 2002, Senators Dodd, Sarbanes, Schumer, and Reid introduced the compromise proposal as a separate bill (S. 2600).[4] Members of Congress from both parties generally agree that liability and potential lawsuits have been major issues of contention.

Initial Industry Reaction

Some insurance industry leaders indicated at the close of 2001 that they would try again in 2002 to get the Senate to adopt a bill. Others, however, opined that it would be too late, and that as policies were renewed in 2002, insurers would be forced to raise their

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[1] (...continued)
RS21075, *Terrorism Insurance in the Post September 11 Marketplace,* by S. Roy Woodall, Jr.

[2] Primary or "retail" insurers spread the risks they assume in their policies by purchasing reinsurance contracts from reinsurers.

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

[4] For additional information on H.R. 3210 and S. 2600, see CRS Report RS21211, *Terrorism Insurance – Comparison of H.R. 3210 and S. 2600,* by S. Roy Woodall, Jr.

premiums substantially, exclude coverage for the terrorism risk from their policies, write it as a separate coverage, or just walk away from providing it altogether. Rodger Lawson, president of the Alliance of American Insurers, said that two things could happen in early 2002 that would force Congress to move quickly on terrorism insurance. The first would be if another major terrorist event were to occur and most policyholders found themselves with no coverage, and the second would be if a major upcoming event such as the Super Bowl or the Winter Olympics were to be hampered by a lack of terrorism coverage. He added, however, that Congress might decide simply to handle uninsured terrorism losses on a disaster basis, by approving payments after future terrorist events.[5] In early 2002, with no terrorism insurance backstop in place, the most dire predictions had not occurred; major economic problems had not materialized, and the momentum for legislation had waned.[6]

Market Reaction

As anticipated, the demand for insurance, especially terrorism insurance, increased after 9/11. At the same time, the industry's capacity for risk shrank as a result of both the 9/11 related claims and the negative effects of a 10-year soft market.[7] In the absence of a federal backstop, market forces reacted as economic theory would predict, by insurers increasing premiums, utilizing terrorism exclusions, or refusing to write terrorism insurance except, perhaps, as a separate coverage.

With the increase in demand for insurance and the drop in supply, prices started to increase substantially. According to a report of the Insurance Information Institute, [8] the rate of increases in most commercial lines of coverage for 2002 before 9/11 was to have been in the 10% to 15% range as a result of the hardening of the market in the normal underwriting cycle. However, after 9/11, the rate of increases for 2002 renewals for many of the same lines roughly doubled to 30%, on average. In other lines of coverage, such as worker's compensation, liability protection against lawsuits, and property coverage for skyscrapers in New York, Chicago, and Los Angeles that are considered prime terrorist targets, prices were running five or six times the level of a year ago.[9] The premium increases have cut into the actual amount of terrorism insurance demanded, and big insurance buyers in many cases are now choosing either to opt for low-level coverage, or to forgo insurance altogether (self-insure), thus taking the risk of future major terrorist events upon themselves.

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[5] Steven Brostoff, "Hope Lives for Terrorism Reinsurance Bill," *National Underwriter, Property & Casualty/Risk & Benefits Management Edition Online News Service*, [http://www.nunews.com/pande], visited Dec. 28, 2001.

[6] Christopher Oster and Michael Schroeder, "Workers' Comp Insurance Now Harder to Get," *Wall Street Journal,* Jan. 9, 2002, pp. A3,A9.

[7] For a discussion of the insurance market cycle, see Gregory Alff, "Returning from a Deep Soft Market and the Largest Catastrophe in History," *Risk Management,* Jan. 2002, pp.18-26.

[8] Dr Robert P. Hartwig, Ph.D., "Earlybird Forecast 2002," *Insurance Information Institute*, [http://www.iii.org/media/industry/financials/forecast2002], visited Dec. 14, 2001.

[9] Joseph B. Treaster, "Insurer's Outlook (Unexpectedly) Good, Despite Big Claims," *New York Times,* Dec. 17, 2001, p.C4.

Terrorism Exclusions

The reluctance of reinsurers to reinsure primary insurers for the terrorism risk and the inability of primary insurers to shoulder the entire terrorism risk themselves has resulted in the increased use of terrorism exclusions in new policies. Under most state insurance laws, such exclusionary clauses are subject to regulatory approval and must be filed with state regulators. This has placed regulators in a not unusual regulatory conflict: a desire to ensure that consumers can be protected against insurable risks, and their duty not to force insurers to assume unmanageable risk and thereby increase their risk of insolvency. The Insurance Services Office (ISO) has filed proposed terrorist exclusions for over 200 insurers. The original filings were made in November and December 2001, and contained a complete terrorism exclusion in anticipation of congressional action.

When Congress adjourned at the end of 2001 without having passed legislation, the regulators voted through their trade association, the National Association of Insurance Commissioners (NAIC), to recommend that the states approve filings of a modified exclusion submitted by the ISO for commercial lines that would only cover losses arising from smaller acts of terrorism. In consideration that Congress might still pass legislation early in 2002, the regulators also recommended that approvals of even the modified exclusions be withdrawn 15 days after the President signs a bill.[10]

The ISO's modified terrorism exclusion language for commercial lines is applicable only if one or more of the following are attributable to an incident of terrorism:

- the total of insured damage to all types of property exceeds $25 million;
- 50 or more persons sustain death or serious physical injury;
- the terrorism involves the use, release or escape of nuclear materials; or
- the terrorism is attempted or carried out by means of the dispersal or application of pathogenic or poisonous biological or chemical materials.

In other words, terrorism coverage is included so long as the insured losses resulting from a terrorist event are less than $25 million; fewer than 50 persons are killed or seriously wounded; and nuclear, biological or chemical materials are not involved. The ISO indicates that the intent of the modification of the original complete exclusion is to provide coverage for smaller events–such as bombing an abortion clinic– which might be defined as terrorism.[11] The exclusion clause also provides that multiple incidents of terrorism which occur within a 72 hour period and appear to be carried out in concert, or to have a related purpose or common leadership, shall be considered to be one incident. As of January 10, 2002, according to the ISO, and since December 26, 2001, the modified terrorism exclusion clause for commercial lines had been approved in 44 states, the District of Columbia, and Puerto Rico. However, the states of New York and California were not among them. With the increase in the use of terrorism exclusions, a new market appears to be developing for the sale of terrorism insurance as a separate line of coverage, not part of any commercial lines package, but generally at high prices.

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[10] The ISO has informed CRS that it has also started making filings for terrorism exclusions for personal lines of insurance (e.g. homeowners), but the NAIC has not yet addressed this issue.

[11] Daniel Hays, "ISO Filings Now Cover $25 Million Terror Loss," *National Underwriter*, [http://www.nunews.com], visited Jan. 4, 2002.

2002 Outlook

Although 2001 was arguably the most difficult and trying year in the history of the property-casualty insurance industry, the forecasts for 2002 suggest that the industry will emerge from the financial shock of 9/11 with its best prospects for growth in many years, as underwriting performance improves substantially. With increased premiums and a high demand for insurance coverage, the industry could grow at its fastest pace since 1986.[12] Analysts point to the big surge in insurance prices after Hurricane Andrew in 1992 and the resulting increase in profits as the insurers more than recouped their losses. Standard and Poors predicts that the upward surge in reinsurance pricing that accelerated after 9/11 also paints a very positive near-term earnings picture for the global reinsurance industry. It predicts that reinsurers will benefit across the board in the near term, and points out that the investment and lending communities which supply the industry with funds have not missed this opportunity. Reinsurers have already raised approximately $25 billion in new capital since 9/11, $6.5 billion going into startup operations and $18 billion going into existing reinsurance operations. In return, the investment and lending communities are looking for 25% to 30% returns on equity.[13] The increased premium rates could also cause insurers to look at innovative capital market alternatives developed following Hurricane Andrew, such as catastrophe bonds, in which insurance risk is transferred to bond holders through the broad and deep capital markets.

Some of the dire economic disruptions predicted in the absence of congressional agreement on a terrorism backstop have not yet become apparent. In particular, banks have not stopped their financing for clients who lack terrorism insurance. Instead, banks are charging somewhat higher fees for some customers who are going without terrorism coverage, when there is a perception of increased risk of default as a result.[14] Lenders have not tightened credit, however, and apparently do not plan to do so for the vast majority of projects; federal bank regulators have indicated that they are not planning to put out any guidance since they have not seen any curtailment of lending.[15] J. Robert Hunter, director of insurance for the Consumer Federation of American, maintains that terrorism insurance is widely available and any federal backstop should be limited to high profile buildings in New York and other major cities.[16] However, according to government sources, there is increasing evidence that some sectors of the economy are beginning to experience difficulties because some properties and businesses are unable to find sufficient terrorism coverage, at any price. Such was the finding of the General Accounting Office in its testimony on February 27, 2002, before the Subcommittee on

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[12] Hartwig, "Earlybird Forecast 2002," p. 1.

[13] Donald S. Watson, "Reinsurance Outlook 2002: Pricing Surge Bullish For Earnings," published Dec. 18, 2001, available at [www.standardandpoors.com], visited Dec. 18, 2001.

[14] Christopher Oster, "Terror-Insurance Costs Cut Into Demand," *Wall Street Journal,* Jan. 4, 2002, p. A4.

[15] Michele Heller, "In Focus: No Terror Insurance, But Lenders Still Lending," *American Banker*, Jan. 7, 2002, pp. 1-2.

[16] Joseph Treaster, "U.S. Is Urged to Be Selective on Terrorism Insurance," *New York Times*, June 11, 2002, p. C12.

Oversight and Investigations of the House Committee on Financial Services.[17] On May 23, 2002, the Joint Economic committee issued a report (available at [http://www.house.gov/jec]), which found that the market for terrorism insurance remains limited, and that the problems associated with terrorism insurance pose a significant threat to sustained economic growth.

The major question for federal intervention remains: at what point is terrorism no longer an insurable risk? To the extent that the insurance industry can underwrite the terrorist risk, it will do so, earn a profit, and help to increase economic stability in the process. But at some point terrorist events, by their massiveness or unpredictability, can cross a line, go beyond the scope of insurance, and have a negative impact on the nation's economy. In such cases, federal intervention may be warranted on economic efficiency grounds, whether on a temporary backstop basis (as considered to date), or on an after-the-fact disaster relief basis. It remains to be seen where the events of 9/11 have redrawn that line.

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[17] U.S. General Accounting Office, *Terrorism Insurance – Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities*, GAO-02-472T (Washington: Feb. 27, 2002), p. 2.