Captives can play a significant role in insuring against terrorism and may help stabilize the market if TRIA is not renewed.

Captives and Terrorism Risk

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The terrorist attacks of September 11, 2001, marked a watershed in the insurance industry. More than two years later, insurers, businesses, and policymakers are still grappling with the challenges that emerged in its aftermath. The most significant issue still remains something of a puzzle: What will happen next time?

One thing is clear: Coverage for another terrorist event goes beyond the capabilities of private commercial lines insurers, which have about $100 billion on the line.[1] Captives, which have always stepped up to the plate to fill critical voids in the insurance market, must play a vital role in creating much needed capacity in a post-September 11 world. This need will be especially urgent if Congress does not extend the Terrorism Risk Insurance Act of 2002 beyond its slated expiration in 2005 — something that seems increasingly likely — creating additional uncertainty in particular insurance markets.[2]

Terror in Insurance Markets

The terrorist attacks caused insured losses estimated at about $40.2 billion, 80 percent of them

for property, business interruption, and liability claims. (See Exhibit 1.) More than half the burden for these losses fell on the reinsurance industry, which then retreated from the terrorism market. To avoid covering such an unmanageable risk, many primary insurers sought to exclude terrorism from policies in the months following September 11. This effort was hampered to some degree by state laws that prohibit such exclusions in workers compensation policies and by laws in nearly 30 states that mandate coverage for fire losses resulting from a terrorist attack. Nevertheless, the inability of businesses to effectively transfer their terrorism risk raised fears that large projects would be cancelled for lack of financing and that organizations without coverage would expose themselves to potential financial ruin.

In November 2002, Congress responded with the landmark Terrorism Risk Insurance Act of 2002 (TRIA), a compromise effort designed to stabilize the availability of insurance protection as well as the overall economy. TRIA established a temporary federal program that provides for a system of shared public and private compensation for insured losses resulting from certain acts of terrorism. It also was intended to provide a transitional period for the private markets to resume pricing of terrorism insurance and build capacity to absorb future losses.

Overview of TRIA

TRIA created a federal reinsurance program for property and casualty losses arising from "certified acts of terrorism" through the end of 2005.[3] The Terrorism Risk Insurance Program falls under the Department for Domestic Finance and the Office of Financial Institutions within the U.S. Treasury Department. It covers acts of international terrorism that cause at least $5 million in aggregate damages. In the case of workers compensation losses, the program covers acts of war as well as terrorism. One area of concern for insureds is that any exclusions for such things as chemical, nuclear, biological, and radiological losses that apply to the policy generally would also be applicable to TRIA losses.

Each insurer has an annual deductible based on its direct earned premium in the prior year for lines of business covered by the program. The federal government is responsible for paying 90 percent of each insurer's primary property and casualty losses above the annual deductible. The amount of each insurer's deductible scales upward each year of the program, from 7 percent of direct earned premium with a maximum aggregate retention of $10 billion in 2003 to 10 percent with a maximum of $12.5 billion in 2004 and 15 percent with a maximum of $15 billion in 2005. Neither the government nor insurers would be liable for losses above $100 billion.

Exhibit 1

Composition of Insured Loss Estimates

Line of Business	Estimated Loss (billions)	Percentage of Total
Property	$9.5	24%
Business Interruption	$11.0	27%
Other Liability	$10.0	25%
Aviation Liabiliy	$3.5	9%
Life	$2.7	7%
Workers Compensation	$2.0	5%
Event Cancellation	$1.0	2%
Aviation Hull	$0.5	1%
TOTAL	**$40.2**	

Source: Insurance Information Institute, July 2002

While the federal government will reimburse insurers for coverage for terrorist acts through 2005, insurers are not required to make coverage available in the last year of the program unless the Treasury Department specifically determines otherwise, a decision that will be made before September 2004.

The program covers commercial lines of insurance, with specific exceptions that include earthquake, fidelity, crop insurance, mortgage guaranty, medical malpractice, the national flood insurance program, health insurance, and life insurance, including group life.[4]

The law also applies to all licensed primary insurers as well as state residual market funds and workers compensation funds, surplus lines insurers and companies listed on the National Association of Insurance Commissioners (NAIC) Quarterly Listing of Alien Insurers, and captives that receive direct earned premiums. Treasury rejected efforts to exclude policies issued by captives, excess insurance policies, and difference-in-conditions policies.

If the federal government pays for insured losses during the course of a year, the Treasury Department will be entitled to recoup the difference through policy surcharges that cannot exceed 3 percent of the annual premium for a policy. The surcharge applies to all policies, whether or not the insurer qualified for reimbursement or the insured purchased terrorism coverage.

The law states that terrorism coverage must not differ materially from the terms, amounts, and other coverage limitations applicable for losses arising from other events, but it does not restrict prices. However, states do retain their authority over rates and forms. Pricing for coverage has been volatile, given the lack of treaty reinsurance to cover insurers' large exposure under TRIA's coinsurance and deductible requirements.

While TRIA has resulted in lower terrorism insurance premiums than were available immediately after September 11 — for small and middle-market accounts, coverage has been offered for free or for just 1 percent to 5 percent of the non-terrorism risk premium — many larger insurance buyers still view the pricing as unreasonable.[5] A survey by the Council of Insurance Agents + Brokers found that fewer than 10 percent of small commercial accounts and fewer than 20 percent of medium-sized accounts purchased coverage offered to them by insurers. Brokers handling large accounts also reported that fewer than 20 percent of their biggest customers bought terrorism coverage. While many smaller businesses believe they are not at high risk for terrorism losses, larger, riskier operations leave themselves exposed because of the cost.[6]

Given the volatile market for terrorism coverage, a growing number of businesses are turning to captives.

Initially, TRIA was vague on the treatment of captives, and captive communities were divided about whether the law should apply to them.

The Captive Markets

Formed in the 1920s and 1930s as an outgrowth of mutual insurers, the captive industry grew up in the 1950s as large companies saw them as a way to transfer risk more efficiently by retaining predictable, high-frequency risks and keeping underwriting cash flow within the corporation. Reduced tax benefits slowed the growth in the early 1970s, but the industry took off again in the 1980s in response to the liability insurance crisis.[7]

Single-parent captives, which underwrite the risks of one company and its subsidiaries, still dominate the captive industry, representing about 75 percent of the 4,526 captives, according to A.M. Best Co.[8] Other types of captives — such as association captives, rent-a-captives, and segregated cell captives — serve the needs of mid-size businesses. In 2001, captives wrote about $38 billion in direct premiums.[9]

Increased demand for captives and other alternative risk solutions is expected in order to address both the reduction in capacity in traditional insurance markets that followed the September 11 attacks and insurers' inexperience in underwriting risks like terrorism.

Treatment of Captives Under TRIA

Initially, TRIA was vague on the treatment of captives, and captive communities were divided about

whether the law should apply to them. Members of the captive community in Vermont — the largest U.S. captive domicile and third largest in the world — wanted participation to be optional for captives. They argued that since many captive insurers were created to operate outside of the traditional insurance marketplace, they should not be treated like traditional insurers in this case. They also argued that some types of commercial coverage provided by captives have little or no exposure to terrorism risk, so they should not be subject to the recoupment provisions. Furthermore, they argued that mandatory participation in TRIA would hamper the development of domestic captives and make setting up offshore captives seem more advantageous.

A memo prepared by a Vermont law firm argued that mandatory participation of captives raises the risk of serious financial consequences, especially for smaller captives that may require additional capital or surplus to meet regulatory standards.[10]

A captive can write terrorism coverage that is tailored to the needs of the corporation and price the coverage to reflect the company's terrorism exposure.

Despite these arguments, other captive communities, such as South Carolina, lobbied in favor of including captives under TRIA. State regulators were divided on how captives should be treated under TRIA. While some favored making inclusion optional, others argued that opt-in treatment would create the potential for adverse selection against the program. When pressed for a decision, regulators generally agreed that including captives was preferable to excluding them entirely.[11]

In issuing final rules for TRIA in July 2003, the Treasury Department rejected opt-in treatment. Allowing for opt-in treatment would create the potential for adverse selection as captives that perceived themselves to have a higher risk of terrorism losses would opt-in while others with lower perceived risks would opt-out. A major consequence, Treasury noted, would be a smaller base of insureds from which the federal government could recoup its share following a terrorist attack that triggered payments under TRIA. Treasury also pointed out that any number of insurers and insureds could argue that they have limited exposure to terrorism and decide to opt-out. It's important to note that not all captives are qualified to participate in TRIA. TRIA applies only to captives that are based in the United States and that receive direct earned premium for included lines of coverage — although offshore captives could probably access TRIA through a U.S.-based facility.

Choices in Handling Terrorism Risk

All businesses, including those with captives, have choices on how they deal with terrorism risk. They can decline coverage entirely (except for workers compensation, which mandates terrorism coverage); they can purchase TRIA coverage from primary insurers; they can buy stand-alone terrorism policies; or they can provide terrorism coverage through their existing captive or establish a captive for that purpose.

Each choice has advantages and disadvantages. Going "bare" obviously puts a company at great financial risk, but for some buyers, TRIA coverage offered through a traditional insurer may be expensive and may lack coverage for non-certified acts. Stand-alone terrorism policies offer the advantage of covering "certified" terrorism acts under TRIA and/or terrorism acts that are not covered by TRIA, such as domestic terrorism or terrorism losses in foreign countries. Brokers have estimated that a handful of insurers were providing between $1 billion and $1.4 billion in stand-alone terrorism capacity.[12]

Electing to use a captive to provide terrorism coverage has its own pros and cons, and each company must consider its own circumstances before making a decision. As it does with other coverages, a captive can write terrorism coverage that is tailored to the needs of the corporation and price the coverage to reflect the best assessment of the company's terrorism exposure. Like other insurers, captives are also free to reinsure the amount of their TRIA deductible and coinsurance requirement. On the other hand, creating a captive to access TRIA where a captive doesn't exist can be costly, though it may be possible to recoup that cost through savings on insurance premiums. Many captives are not capitalized well enough to fund terrorism

losses, leading to solvency concerns. Sponsors may be reluctant to pour capital into their captives to support the additional exposure. Captives face the same challenge that every insurer faces of accurately pricing terrorism coverage, a challenge made more difficult because of the lack of historical experience and the unpredictable nature of terrorism losses. While a number of insurers have bought or developed software that attempts to model terrorism losses, most captives lack the capability to model risk for this and other catastrophe exposures in a sophisticated fashion.

Many captives are not primary writers and, therefore, cannot directly access reimbursement as mandated by TRIA. Businesses often must show evidence of insurance from a licensed insurer admitted to do business in a particular state. To do this, many captives use a commercial insurer. A commercial insurer issues primary policies to the captive's owner, and the risk is then transferred to the captive insurer through a reinsurance agreement. Limited capacity is already a major problem facing the captive industry. It will be even more difficult for captives to secure such relationships for terrorism coverage, because commercial insurers will understandably be concerned about the captive's ability to cover the loss. Insurers assume a significant amount of credit risk in such relationships, so the key question is how much collateral a primary insurer should require to protect against a catastrophic event. Another challenge for both captives and primary insurers providing terrorism coverage is the extremely tight reinsurance market.

Despite the challenges, brokers have reported growing interest in using captives to provide terrorism coverage. As of July 2003, Marsh USA Inc. reported that "20 existing captives added TRIA coverage, one new captive was formed for that purpose, and at least 13 companies were considering captive-related options for TRIA coverage."[13] As of late September 2003, Aon Risk Services was aware of at least 40 captives that had issued a TRIA policy, and two captives had been formed in New York to access TRIA.

The lack of pricing restrictions has led some consultants to suggest that captives could charge minimal premiums for high limits on terrorism policies, thereby reducing the deductible the captive would have to pay before TRIA would start paying for losses. But companies that set up captives for the sole purpose of providing "cheap" terrorism coverage might be assuming a great deal of risk. At a forum in June 2003, Mario L. Ugoletti, deputy director of the Treasury Department's Office of Financial Institutions Policy, expressed concern about any strategies that might be developed for captives to "get around" or "game" TRIA. "While Treasury wants to encourage new and sustainable risk-sharing mechanisms," he said, "we also have an obligation to maintain the integrity of the program."[14]

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Many Uncertainties

Even as TRIA has created some stability in the market for terrorism coverage, there are still many areas of great uncertainty. Workers compensation is one of the most significant concerns.

Workers compensation provides unlimited statutory coverage. Captives often reinsure the parent corporation's large workers compensation deductible under the policy — typically the first $250,000 to $500,000 of loss per occurrence — thus limiting their ultimate liability. The fronting insurer retains a tremendous amount of terrorism risk in excess of the deductible. Prior to September 11, workers compensation was generally considered a frequency-driven line with limited exposure to catastrophic losses. The experience modifier used to adjust each policy premium, for example, is heavily weighted with each given insured's frequency of claims, not the severity. After September 11, the exposure of potential enterprise-level severity losses became a critical new challenge. The National Council on Compensation Insurance (NCCI), for example, estimates the total September 11 workers compensation losses at around $2 billion, easily the largest such loss event ever. If one workers compensation insurer had insured all or even a majority of these employees, which is entirely possible, paying for the losses on September 11 would have eroded its capital base, unless it was among the very largest prop-

erty-casualty insurers. If TRIA is allowed to expire on December 1, 2005, with no form of federal relief extended, a new workers compensation availability crisis appears to be a strong probability, particularly in key urban centers and perceived high-risk industries. This will present a new opportunity and challenge for captive insurers to partner with traditional insurers to develop the best possible private sector solution. Captive owners can expect to see a great deal of volatility in the excess workers compensation market after TRIA expires.

Recognizing this eventuality, a 14-member group of insurers has been working together to create a terrorism reinsurance pool for workers compensation risks, but the effort is moving slowly with no consensus among the insurers, making it uncertain, at best, whether such a pool will ever come to fruition.[15]

Risk managers have no commonly accepted standards for minimum benchmarks for security and other measures to mitigate terrorism losses.

Excess liability coverage is another area of uncertainty. Excess liability policies provide additional liability coverage when coverage under the primary policy has been exhausted. As TRIA was being debated in Congress, there were efforts to limit liability for third-party and punitive damages, but the limits never made it into the final Act. As with other commercial coverage, insurers providing excess liability policies must make terrorism coverage available to insureds. With the final version of TRIA excluding federal reimbursement for punitive damages and with no clear definition of negligence, many insurers are worrying about the quality of excess liability coverage for higher-risk accounts.

Additionally, reinsurers have made it clear that they will continue to limit their exposure to terrorism losses until they are better able to understand and price the risk. While TRIA brought reinsurers gingerly back into the terrorism market, it is unlikely they will remain when it expires.

More Challenges Ahead

In enacting TRIA, federal lawmakers sought to create a temporary program that provides a system of shared public and private compensation for insured losses resulting from acts of terrorism in order to address market disruptions and ensure the availability and affordability of property and casualty insurance for terrorism risk. The expectation was that the three-year program would provide a transitional period for private markets to stabilize, resume pricing of terrorism insurance, and build capacity to absorb future losses.

The assumption was that with a temporary security blanket, insurers and reinsurers would become more comfortable underwriting terrorism risk, giving rise to a robust voluntary market for affordable terrorism coverage. But the "efficient market" assumption does not seem to be holding up, and from today's vantage point, it seems that TRIA is unlikely to achieve its goal.

Take-up ratios for terrorism insurance have been low, though businesses closer to high-risk targets are more likely to purchase terrorism coverage. Without the protection afforded by TRIA, insurers may consider that this kind of adverse selection will result in an unacceptable concentration of risk. The lack of progress on the terrorism reinsurance pool for workers compensation risks is indicative of the challenges insurers would face creating any type of solution that relied entirely on the private market.

Time is running out. Although TRIA does not expire until the end of 2005, insurers have less than a year to determine what their underwriting approach will be, based on the assumption that no federal relief will be available as of January 1, 2006. In all likelihood, insurers will begin to radically adjust their portfolios, and an increasingly chaotic market will emerge.

Positive Developments

To avoid an increasingly chaotic market, private and public sector insureds and organizations need to work together with insurers to address critical needs. While the prospects of a stable market for affordable and available terrorism insurance post-TRIA seem rather dim, some positive developments under way could improve the situation.

State legislators are beginning to recognize the

danger facing insurers due to unlimited terrorism liability. A number of states are changing laws that do not allow exclusions for fire resulting from terrorism even if the policyholder rejects terrorism coverage. About 29 states, representing 70 percent of the U.S. insurance market, had such laws, but at least seven states have since overturned or amended them and others are considering similar action. The issue is critical, in that it allows insurers to assert some limits on their terrorism liability.

Among the most promising developments is the work under way by the RAND Center for Terrorism Risk Management Policy. The center was recently established to provide the objective research necessary to guide public policy on terrorism risk insurance; terrorism liability, including issues related to potential chemical, biological, and radiological attacks; and compensation for victims of terrorist attacks.

The Center's most immediate goal is to inform the debate over the renewal of TRIA. To do this, the Center is designing several projects to simulate and analyze the insurance and compensation implications of terrorist attacks with and without TRIA and under other possible government and private terrorism risk pools.

The Center also will develop research to improve the mathematical models used to create terrorism risk management tools and to help public and private entities make decisions about appropriate security to mitigate terrorism risks.

A lot of good work has been done to improve loss control, but risk managers still have no commonly accepted standards for minimum benchmarks for security and other measures to mitigate terrorism losses. High levels of security may not deter attacks, but they do reduce losses and save lives. Unfortunately, commercial property in the United States is generally not well protected. In June 2003, Risk Management Solutions, a catastrophe-modeling firm working with RAND, surveyed 125 high-rise targets in New York. Three-quarters of the properties allowed vehicle access right up to the building, even though improvements to stand-off distances can significantly reduce the risk of damage from a car bomb.

The Center's research may lead to a consensus for benchmarks for terrorism loss control that could provide a safer environment for businesses and lower terrorism risk insurance premiums.

The Need for Captives

It would be wonderful if the need for terrorism insurance expired along with TRIA. Unfortunately, we know too much to believe that possible. Terrorism risk is real. Experts believe additional significant terrorist attacks on U.S. soil are likely to occur.

We cannot ignore the very real likelihood that insurance and reinsurance capacity for terrorism coverage will plummet when TRIA expires. The capital of the captive market is crucial to building the capacity that is needed to mitigate the net risk to the insurance industry. Captives may be able to use their capital to reinsure the terrorism risk.

Not many individual captives have that capability, so the solution may take the shape of a pool for businesses at the highest risk, particularly commercial properties in target areas. A high-risk terrorism pool could provide a first layer of protection so long as the government would be willing to provide additional protection.

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The Real Estate Roundtable, an industry group representing the nation's largest commercial property owners, appears to be exploring various private and public sector solutions that could be enacted after TRIA sunsets in 2005. The pool concept is one of the options being examined. An appropriate model can be found in Pool Re, created in the early 1990s in the United Kingdom after the international reinsurance market retreated as a result of Irish Republican Army (IRA) terrorism. Pool Re provides excess cover for property damage and business interruption, and the British government acts as Pool Re's reinsurer of last resort.

The future of the voluntary insurance market is at stake. Terrorism transcends all traditional notions of insurance and limits of the private sector. Establishing a collaborative approach between the public and private sector is necessary to ensure the future of the voluntary insurance market of the United States.

Trying times call for creative solutions. Throughout their history, captives have stepped in to fill voids in the insurance market. Now, at another crossroads in the insurance industry, captives have a tremendous role to play in providing financial protection against terrorist attacks for U.S. businesses.

Endnotes

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