

American Enterprise Institute

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Should The Terrorism Risk Insurance Act of 2002 Be Extended?

***Terrorism & TRIA:
Myths, Realities and Alternative Conclusions
(supported by findings in the Treasury Report)***

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Presentation Overview

- **Terrorism & TRIA: Myths, Realities**
- **Alternative Conclusions (supported by findings in the Treasury Report)**
- **What's Next?**

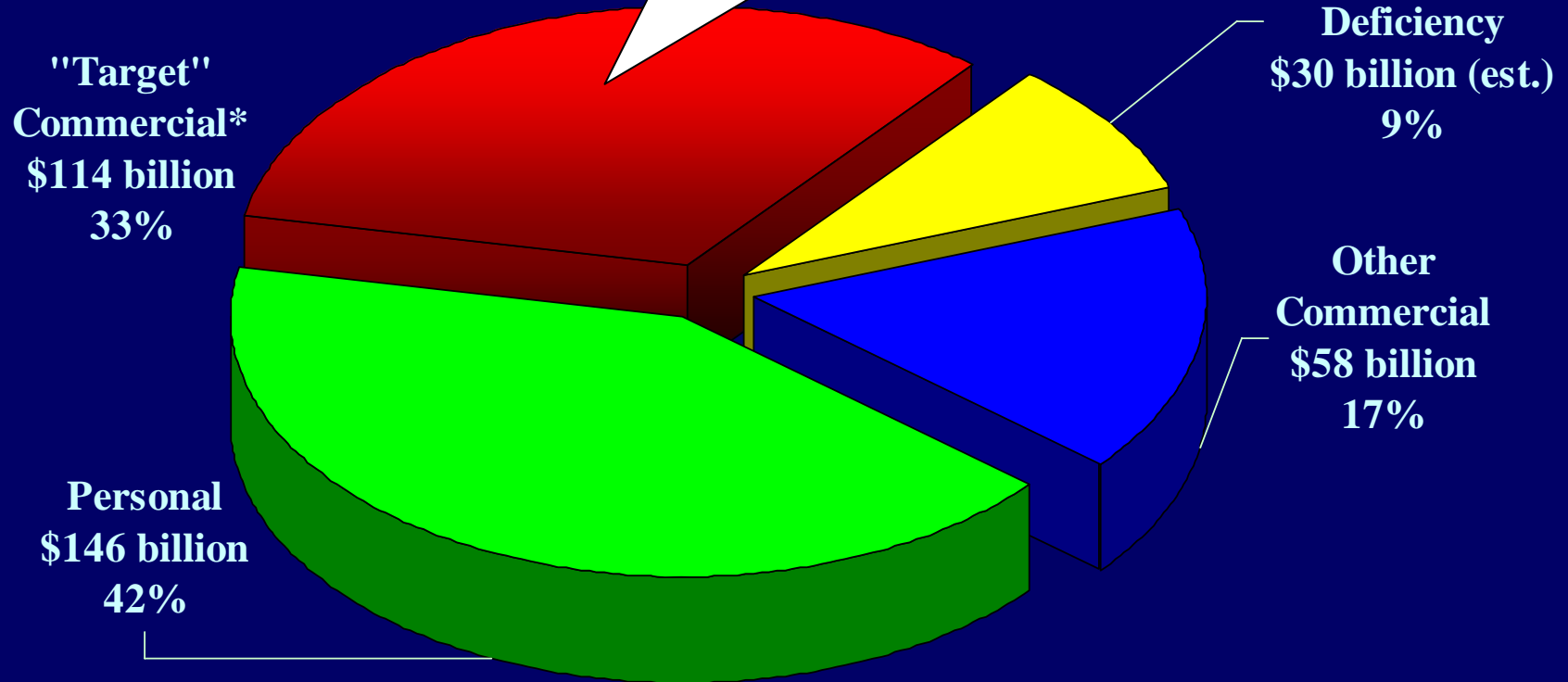
TRIA Myths: Six Roadblocks to a rational solution

- **Capital Myth**
- **Preparedness Disincentive Myth**
- **“Free Market” Myth**
- **“No Historical Precedent” Myth**
- **“Bail-out” Myth**
- **“Free Reinsurance” Myth**

Capital Myth: US P/C Insurers Have Over \$350 Billion to Pay Terrorism Claims?

Total PHS = \$298.2 B as of 6/30/01
 = \$291.1 B as of 12/31/02
 = \$347.0 B as of 12/31/03

Reality: Only 33% of surplus backs "target" lines net of reserve deficiency. As GAO report states, only a "portion" of this would be available pay terrorism losses.



*"Target" Commercial includes: Commercial property, liability and workers comp; Surplus must also back-up on non-terrorist related property/liability and WC claims

Sources: Insurance Information Institute estimates based on A.M. Best Q.A.R Data. GAO 05-199, "Catastrophe Risk"

February 2005 p. 12-13

Preparedness Myth: Is TRIA a disincentive to private sector self-protection?

Reality: Most major employers have improved preparedness for numerous unrecognized reasons:

- **“Do the Right Thing”:** Workplace safety is already a legal, regulatory & moral requirement (e.g., OSHA).
- **Sarbanes Oxley:** Federal law ignored by TRIA critics and not scheduled to expire, with positive impacts on preparedness (e.g. business continuity planning, enterprise risk management).
- **Key Conclusion of *both Treasury survey and Marsh 2005 survey*:** Perception of risk, not cost or availability of terrorism insurance, drives self-protection investment decisions. The “asymmetric information” problem unique to terrorism makes informed, private sector self-protection decisions impossible.

“Free Market” Myth: Will an efficient market emerge without TRIA?

Reality: The expiration of TRIA *would not* enable a “free” market for terrorism insurance because:

- **State Regulation:** Over 51 jurisdictions regulate insurers. Some prohibit all terrorism exclusions on all commercial lines.
- **Workers Compensation (all jurisdictions) & SFP “Fire Following” States:** Prohibit exclusion of terrorism losses.
- **Limited Traditional Reinsurance** (particularly for NBCR)
- **Flawed Economic Assumption?**

Anti-TRIA arguments frequently assume a government role requires a “market failure”. This ignores the unique role and responsibility of federal government when national security and economy are threatened.

“No Historical Precedent” Myth

Reality: Federal government has a long tradition of addressing natural and man-made social, political and economic risks threatening the U.S. economy and exceeding the capital risk-taking ability of the private sector.

Man-made “extreme event” risks have resulted in the following federal solutions:

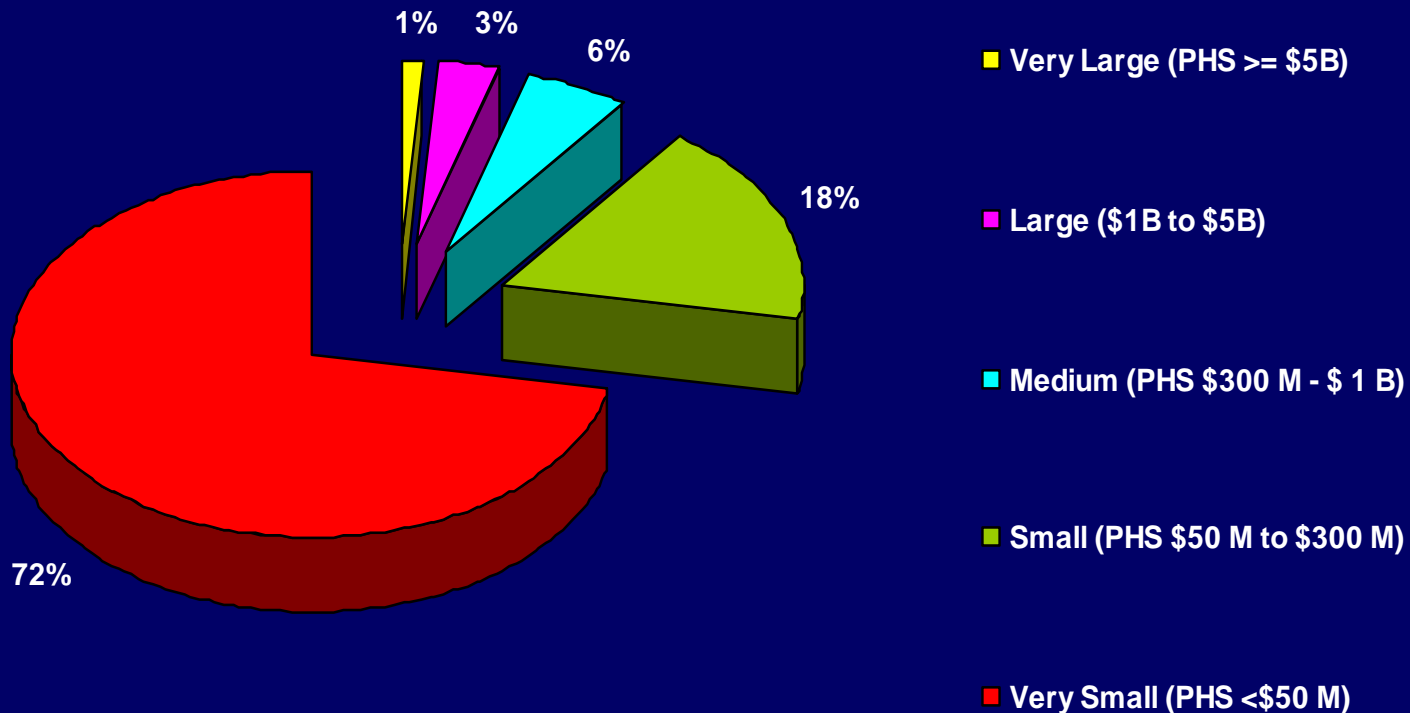
- **FDIC (1933)**
- **War Hazards Act (1947)**
- **Price Anderson Act (1957)**
- **Urban Property Protection and Reinsurance Act (1968, expired)**
- **OPIC (re-authorized in 2004)**

“Bail-Out” Myth: TRIA was a “bail-out” for insurers post 9/11; Deductibles need to be increased.

Reality:

- Insurers are expected to pay \$32.5 B from 9/11 loss with no federal relief.* RAND Corporation report estimates insurer “qualified benefit” 9/11 expenditures at \$19.6 B through mid-2004 (51% of total) compared to Government \$15.8 B (42%) and Charity \$2.7 B (7%).**
- The Treasury report itself suggests that large Insurer deductibles are *already too high* (p 68-69, p. 114).
- This myth ignores the significant implicit charge to insurer capital effected by making the TRIA insurer deductible inclusive of commercial lines premium even when policyholder rejects TRIA coverage (and the insurer therefore receives no premium).

P&C Market Reality: Vast majority of domestic commercial underwriters have less than \$500 M in group capital (PHS) – *The minimum \$500 M terrorism insured loss trigger proposed by Secretary Snow would make any new law virtually useless for all but the largest insurers in the event of an uncorrelated large loss.*



Based on an independent assessment of over 1,100 P&C insurers 2003 results by ACE USA.
Data source: AM Best. Excludes most Personal Lines insurers and medical malpractice specialists.

“Free Reinsurance” Myth

The Treasury report and many others characterize TRIA as a form of subsidized or free “reinsurance.” This is misleading because:

Reinsurance (1) Is always negotiated freely by equal parties, (2) Reinsurers never have sole discretion to “certify” an event; (3) Reinsurers can never require insurers to provide coverage and dictate the terms of coverage.

Reality: TRIA is best understood as a necessary “indemnification agreement” for foreign-sponsored acts of terrorism, reflecting the fact that the private sector is the surrogate target for actions resulting from the foreign policies of the federal government.

Alternative Conclusions

(Supported by findings within the Treasury Report)



- The modeling of terrorism risk has improved but it does not currently provide a reliable basis for traditional insurance pricing (see “Remaining Challenges”, page 126). Therefore, “actuarially fair” pricing is not possible.
- “Large insurers, especially diversified insurers offering coverage in several lines, face a terrorism risk deductible that is significant in dollar terms.” (p. 114) The insurer deductibles should therefore not be increased by an extension or new program, as proposed by Secretary Snow.

Alternative Conclusions (Continued)



- Treasury recognizes that TRIA has achieved its most important goals but gives no expressed credit for positive economic developments. Along with tax cuts and monetary stimulus, TRIA *must be given some credit* for aiding GDP growth from 2.3% in 2002 to 3.9% in 2004 and unemployment reduction from 6% in 12/02 to 5.1% in 5/05 (page 139). We note that Congress establishes the “critical” role of available and affordable commercial insurance to “economic growth” in the first section of the law (see TRIA, Section 101 (a) (1)).
- The Treasury report cites “striking” increases in large policyholder 2004 take-up rates. Treasury discounts the importance of this development because of inferred “attrition bias” in their survey. We believe it is inappropriate to totally ignore these survey results. The take-up increase indicates a very encouraging trend that the expiration of the law will likely terminate (page 51).

Alternative Conclusions (Continued)



- “Comparing provision of non-certified coverage to certified coverage, we find more insurers writing certified terrorism insurance overall *and* within in each insurer-size class than non-certified coverage. This comparison suggests that TRIA has encouraged insurers who otherwise would likely not have participated in this market to write certified terrorism coverage.” (Page 79)

What's Next?



Based on all of the above observations, the fact that terrorism risks today are as great or greater than they were in 2002, we believe that most underwriters agree that large scale terrorist attacks *are simply uninsurable without government support* (supported by Alan Greenspan's recent remarks).

In addition, the following issues need to be addressed in any revision to the current law:

- The unique issues faced by Workers Compensation insurers given their statutory inability to exclude or limit terrorism coverage,
- The extremely low Property take-up rates specifically for NBCR cited in the Treasury report,

What's Next? (Continued)



- The “perception of risk” problem discouraging self-protection (and the likelihood that absent new guidance Americans *will always believe* in Aristotle’s definition of “luck” as “the arrow hitting the other guy”),
- The still too-low approximate 50% Property Insurance take-up rate, and
- As proposed by Secretary Snow, the need for some new, rational basis to limit possible abuses of our liability system. The Safety Act could serve as a precedent, possibly tied to compliance with new minimum preparedness standards to some form of limited liability.