UNDERSTANDING THE TERRORISM RISK INSURANCE PROGRAM

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INTRODUCTION

Since the events of September 11, 2001, the federal government has developed a robust and sophisticated counter-terrorism apparatus that has thus far succeeded in preventing large-scale terrorist attacks on the United States homeland. However, the threat of terrorism is continuing to evolve amid a changing, unstable, and dangerous international environment. Attacks such as the Boston Marathon bombing are stark and painful reminders that the United States must remain vigilant. Unfortunately, it will likely never simply be about prevention – response and recovery are also integral pieces of the country's national security. It is vital that we, as a nation, protect the U.S. economy from the financial devastation that could accompany a catastrophic terrorist attack and help get it back on its feet after an attack.

Insuring against the losses from such an attack could be one way to achieve that vital protection. However, simply put, terrorism is not an insurable risk as it involves strategic human behavior and represents a dynamic threat that is intentional, responsive to countermeasures, and purposefully unpredictable. The objectives of terrorists, the means and methods of achieving those objectives, and the propensity to collaborate with unknown national and international actors are not knowable or measurable in a commercial context. Compare this with hurricanes and floods, which, as forces of nature subject to relatively stable and statistically predictable laws of behavior, enable insurers to predict the frequency and severity of such risks, and therefore, to properly underwrite them on both a local and catastrophic basis. In short, insurers cannot underwrite risks that lack a statistically reliable foundation.

Following 9/11 it became evident that no self-sustaining private market for terrorism risk coverage was likely to develop. Therefore, in 2002, Congress passed the Terrorism Risk Insurance Act, or TRIA, creating a risk-sharing mechanism between the private and public sectors. This mechanism allows for a large and temporal transfer of risk that would not occur in a fully private market but does – potentially exclusively – utilize private capital.

The TRIA program creates the space to allow a viable private market to function. The unique structure of the program's recoupment mechanism takes losses that could render a single company insolvent and spreads them throughout the private sector and over time. This has created the certainty needed for the commercial insurance industry to effectively operate and policyholders to purchase coverage that would otherwise be unavailable. Now, losses from all but the largest terrorist attacks are completely borne by the private sector without involvement of the TRIA program.

The purpose of the program is to make sure that the economy can recover in as orderly a fashion as possible from a terrorist event. In order to encourage private-sector involvement in the terrorism insurance marketplace – and thereby protect and promote our nation's finances, security, and economic strength – the U.S. needs a well-functioning terrorism loss management plan. Fortunately, the current TRIA program has proven to be such a plan.

CREATING THE TRIA PROGRAM[1]

Before the events of 9/11, the abstract possibility of a major terrorist attack on the U.S. was known but not understood by most people. At the time, terrorism was typically included in "all-risk" policies because the risk was deemed so small as to be incalculable. Then, in one morning, the 9/11 attacks caused roughly $45.5 billion in insured losses.[2]

Soon after the attacks, reinsurers and then insurers moved to exclude terrorism coverage from their new and renewing policies as this was a poorly understood risk that could potentially produce previously unimaginable losses. Consequently, the ability of commercial policyholders to purchase adequate coverage at affordable prices was severely constrained. As a result, many were forced to go without coverage or only partly insure their assets. In states that prohibited carriers from excluding coverage for terrorism and with reinsurance companies universally excluding terrorist acts in property/casualty treaties, most carriers only alternative was to offer less coverage or not write the business at all.

The lack of adequate insurance capacity and significant increases in pricing of commercial multi-peril business resulted in the postponement or cancellation of many construction projects. It was estimated at the time to have delayed or cancelled $21 billion[3] in real estate transactions and cost 300,000 construction workers their jobs.[4] Given the economic uncertainty this created and the insurance industry's serious concern about properly managing this risk, Congress passed and President George W. Bush signed into law the Terrorism Risk Insurance Act of 2002. It was quickly realized that without the program American businesses would be hard pressed to find or afford the coverage they needed, so TRIA was extended for two years in 2005, seven years in 2007, and again for six years at the beginning of 2015.

Essentially, TRIA limits an individual company's potential terrorism losses, which permits them to quantify their terrorism exposure and make coverage available. The program was purposefully designed to force insurers back into the terrorism insurance market in exchange for this loss limitation in the event of a certified terrorist event.

There are several key elements to the program:

- **Required Offering of Terrorism Coverage:** The current program requires all insurers selling covered lines to offer terrorism coverage, compelling many insurers that had previously exited that market to return and dramatically reducing the amount of potentially uninsured losses in the event of an attack. Insurers are required to offer coverage for acts of terrorism on the same terms and conditions as other coverages, although this does not include coverage for nuclear, biological, chemical, and radiological-attacks. Currently policyholders are not required to purchase the offered coverage, and in the last few years take-up rates have plateaued in the 60 percent to 65 percent range.
- **Certified Act of Terrorism:** In order to involve the TRIA program, an individual act of terrorism must be certified by the secretary of the Treasury in consultation with the secretary of Homeland Security and the U.S. attorney general. To be a certified act, losses must exceed $5 million.

[1] This paper will be using the Terrorism Risk Program's statutory numbers for the year 2020 throughout.
[2] All dollar amounts in this paper are calculated using 2019 dollars.
[3] Real Estate Roundtable, "Survey Confirms Economic Toll of Terrorism Insurance Gap: Over $10 Billion of Real Estate Projects Affected Across U.S.," September 4, 2002
[4] President George W. Bush, "President Reiterates Need for Terrorism Insurance Agreement," October 3, 2002.

- **Program Trigger:** Best conceived of as a "light switch," the TRIA program is "switched on" only if the insurance industry's aggregate insured losses exceed $200 million in a given year. Once "on" the trigger level has no bearing on the federal government's share of the losses in a specific event.

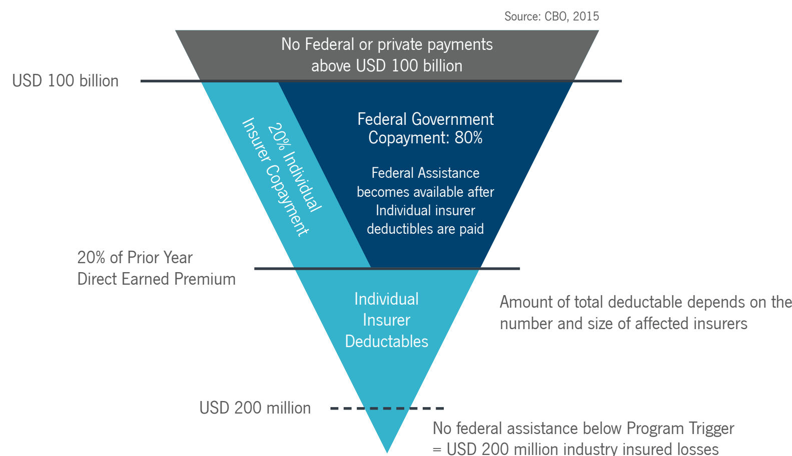
- **Deductible:** Each insurer is responsible for paying out a portion of its claims – the "deductible" or "individual company retention level" – before any federal involvement. An insurer's deductible equals 20 percent of an insurer's annual direct earned premiums from the year prior to a certified event from covered TRIA lines. For some companies, these deductibles are in the billions of dollars.

- **Co-Share:** For each insurer's losses above its deductible, the insurer covers 20 percent and the federal government covers 80 percent until the amount of losses totals $100 billion, after which there is no requirement that insurers or the government provide coverage.

- **Mandatory Recoupment:** By law, the federal government must recoup the difference between insurers' total costs and the industry aggregate retention level, which is calculated as the sum of all the individual company deductibles estimated at $46 billion. This recoupment takes place in the years following the federal sharing of insurer losses, with the Treasury Department establishing surcharges on all covered commercial policies and is required to recoup 140 percent of the initial outlays to insurers under the program. This mandatory recoupment will not apply for losses above the industry aggregate retention level. In that case, however, the Treasury secretary retains discretionary authority to apply recoupment surcharges for all losses above this level. Ultimately, every dollar spent by the federal government is recoupable under current law.

To reiterate, taxpayers are completely protected under TRIA. The program essentially acts as a post-funded payment mechanism for the catastrophic tail coverage of terrorism risks. This coverage is valuable but not priced explicitly nor paid for upfront – it is paid for in the event it is used and in effect pricing is determined after any event. This structure is common for risks that are more difficult to quantify and where there is great uncertainty as to the range of possible outcomes – nuclear power plant disasters are another example.

It is this structure of the current TRIA program that has created space for a private market to operate under the umbrella of federal participation. Private-sector involvement reduces the unaddressed financial needs of victims, which, in turn, reduces the necessity of government intervention – thus taxpayer exposure – post-attack. Just as important, what TRIA does is define the government's role in advance of a catastrophe rather than relying on ad-hoc authorizations after the fact, thus allowing all parties to plan efficiently.



PUTTING THE TRIA PROGRAM INTO PRACTICE

Imagine a certified terrorist event in Chicago in 2020 that causes $25 billion in total losses for covered lines, such as workers' compensation, property, and business interruption. Determining coverage and payment proceeds as follows:

STEP 1: Determine which losses are covered.

For workers' compensation insurance, no terrorism exclusions are allowed, so all losses will be covered, but for property or other lines the policyholder had a choice to accept or reject terrorism coverage. Review of the policies and coverages will determine whether the losses are covered.

Let us assume for illustration purposes that $20 billion of the $25 billion in losses are covered.

STEP 2: Determine if TRIA program is triggered.

The $20 billion in covered losses exceeds $200 million program trigger level so the program is triggered.

STEP 3: Insurance companies process claims and pay all insured losses.

Each individual insurer that sustained losses processes its policyholders' claims and pays all insured losses, which, in this example, total $20 billion.

STEP 4: Insurance companies calculate their share of insured losses.

First, each insurance company calculates its deductible based on the formula – 20 percent of applicable 2019 premium, the year prior to the certified event. For purposes of illustration, imagine all insurance companies involved have deductibles that equal $5 billion.

Second, each insurance company calculates its 20 percent share of losses above its deductible up to the total program cap of $100 billion. In this example, the insurance companies co-share is another $3 billion, which is 20 percent of $15 billion, the amount of the sum of $20 billion in covered losses minus $5 billion in deductibles.

STEP 5: The federal government reimburses insurers for a portion of the insured losses.

The federal government reimburses insurers for losses not covered by the insurers' deductibles and co-share. In this case, the federal government's share is $12 billion: $20 billion in losses minus $5 billion in insurer deductibles minus $3 billion in insurer co-share.

STEP 6: Determine recoupment by the federal government.

Because the total insurance industry cost of $8 billion did not exceed the estimated industry aggregate retention of $46 billion, the federal government is required to recoup 140 percent of the $12 billion in TRIA outlays through premium surcharges, or $16.8 billion.

(NOTE: If the event had been big enough that the total insurance industry costs met or exceeded the industry aggregate retention of $46 billion, the Treasury secretary has the discretion to pursue further recoupment of all monies).

SUMMARY: Under this $25 billion loss scenario ($20 billion in covered losses), policyholders who made a conscious choice not to purchase terrorism coverage would end up paying or absorbing $5 billion. Affected insurers would be responsible for paying $8 billion and the federal government would pay $12 billion initially. All policyholders and commercial insurers would be assessed $16.8 billion through surcharges on policies going forward to repay the government.

Net to the federal government: +$4.8 billion

Total Covered Losses	$20B
Insurer Deductibles	$5B
Insurer Co-Sharing	$3B
Total Industry Losses	$8B
Initial Government Outlay	$12B
Mandatory Recoupment	$16.8B (140% X $12)
Net to Federal Government	+$4.8B

WHY IS THE PROGRAM NECESSARY?

Managing terrorism risk defies the normal underwriting practices of insurers. Terrorism involves strategic human behavior and represents a dynamic threat that is intentional, responsive to countermeasures, and purposefully unpredictable. Immediately following 9/11, some held out hope that, given time, modeling and underwriting methods could be developed and utilized to help insurers manage terrorism risk. And indeed, much has been done to develop modeling tools to manage aggregate loss exposures that are based on a predetermined event of a certain magnitude in a given area. However, due to the nature of terrorist events, it is not possible to use history to model where an attack is likely to happen or the potential frequency of attacks.

The reasons for the difficulty of underwriting terrorism risk are numerous and profound:

- **Identical to Acts of War** – Acts of war have always been considered uninsurable events, with either an implicit or explicit expectation that financial responsibility resides with the governments involved. War-related damage has never been covered by insurers and no one has suggested that something must be done to maximize private-sector capital to be used to provide such coverage. Simply because stateless, transnational groups are perpetrating these acts of terror does not categorically change their war-like nature.

- **Absence of Meaningful Actuarial Data** – The data that insurers normally rely on when considering whether coverage can be offered and, if so, at what price, either does not exist or is not available. In the case of natural catastrophe risk, a company can rely on decades of relevant event data that can be plugged into mathematical models to quantify risk – there is no comparable historical record on which to draw for large-scale terrorist events. Further, much of the relevant data that might be used by an insurance company is appropriately kept secret by the federal government for national security reasons. Without access to this type of information insurers cannot meaningfully calculate the likelihood, nature, or extent of a potential event, making pricing and reserving virtually impossible. Although in theory access to classified information might paint a more accurate picture of the threat matrix facing targets in the U.S., insurers should not – and are not asking to – be given state secrets to write terrorism coverage.

- **Intentional Acts** – Terrorist acts are deliberate acts and do not occur randomly. Because of this, there is no way to determine the probability that a particular property or asset will experience a terrorism-related loss. Part of the difficulty in assessing terrorism risk stems from the fact that, because of response measures taken in the wake of an attack, the next event is unlikely to follow a similar pattern. Unlike criminal acts, such as robbery, where the goals are predictably targeted, the goal of maximizing death and destruction can be accomplished in countless ways, anywhere and at any time. And terrorism is not comparable to a random event – a hurricane does not study wind-damage mitigation efforts and then think up new ways to get around them. The only truly effective mitigation tools – if there are any – reside within the government's national security apparatus, but as noted above, these are understandably kept secret.
- **Risk Concentration** – Terrorism risk is highly concentrated and incredibly difficult to effectively pool across geographical locations and policyholder type, particularly in an age of mass-casualty terror. Acts of terrorism on the scale of 9/11 are what are known as a "clash events," meaning they cause significant losses across multiple lines of insurance. These types of events directly threaten the solvency of both insurers and reinsurers and are not typically covered risks. In a fully free market, it would likely be the case that highly concentrated urban areas in particular would find it difficult to find or afford coverage for terrorism.
- **Interdependencies** – At the very highest level, the nation's foreign policy decisions and the effectiveness of its homeland defense have a direct impact on the likelihood and success of an attack. At the policyholder level, the vulnerability of one organization is not simply dependent on its own security decisions, but also on the decisions of other organizations and agents beyond its control.

In the end, it is more accurate to think of the TRIA program's purpose not as providing reinsurance for losses resulting from "acts of terrorism," but as protection from losses that result from a failure in the government's systems for detecting and preventing acts of terrorism. With respect to natural catastrophe risk, it would be absurd to assign to a government agency the task of preventing hurricanes, tornadoes, and earthquakes. But it makes perfect sense for citizens to expect their government to prevent attacks by America's enemies, and that is precisely what Americans have come to expect from their government in the aftermath of 9/11. It is now widely recognized that one of the federal government's fundamental duties is to prevent terrorist attacks through effective counter-terrorism measures. Only if the government is unsuccessful in interdicting terrorist plots will Americans incur terrorism losses. "Terrorism risk" is best understood as the risk of government counter-terrorism failure.

Accordingly, while the private insurance industry is willing to assume a substantial portion of this risk within the limits of its capability, the ultimate responsibility for managing the risk of counter-terrorism failure does and should rest with the federal government.

TRIA STRUCTURE DESIGNED FOR INDIVIDUAL COMPANY PARTICIPATION

Discussions surrounding the private terrorism risk insurance market tend to focus on aggregate numbers – i.e. how much market capacity exists, industry exposures, etc. However, the design of the TRIA program focuses on something entirely different and more appropriate for its purpose: the individual company. The program is structured this way to take into account the unique risk discussed above and the fact that losses are not likely to be spread evenly among a large number of insurers even in a catastrophic attack.

This is especially so in the case of terrorism because perpetrators have the ability to precisely target particular properties or assets. Hence, a single terrorism event could affect insurance companies with similar books of business in very different ways: one company might suffer no losses from the event, while another company could suffer losses sufficient to threaten its very

existence. The TRIA program – through the mechanism of initial federal outlays recovered through recoupment – allows this "bet the company" risk to be spread throughout the private sector and over time in a manner that cannot be duplicated by the private sector alone.

Further, the individual company retention and co-share percentages are all set at levels with the individual companies in mind, not the overall industry. A single company's capacity to absorb losses cannot be exposed beyond a reasonable level without failing in its primary purpose – supporting the economy by protecting against non-terrorism-related losses and events. In the event of a major attack, substantially depleted reserves and surpluses, as well as insolvencies, could mean that policyholders of non-covered lines could go unprotected. A company that engages in business that endangers the ability to pay on existing or future claims is violating its duties to existing policyholders, another reason the TRIA program is designed the way that it is.

WHAT WOULD HAPPEN IF TRIA EXPIRED OR WAS MATERIALLY CHANGED?

Termination of the TRIA program threatens the space in which a viable private market for terrorism insurance has grown. In considering what is likely to happen if the program were to terminate on December 31, 2020, the immediate aftermath of 9/11 in commercial property/casualty insurance markets for terrorism coverage as described above is instructive.

The effects of a termination of the TRIA program also extend beyond the property/casualty insurance industry. As we saw, commercial development can grind to a halt in the absence of terrorism coverage if the financial institutions financing projects require the coverage as a condition of their loans. In fact, many outstanding loans that require developers to maintain coverage would be thrown into technical default if the program were terminated and if insurers had made arrangements to exclude or limit coverage in the absence of TRIA. The impact on the broader economy was one of the key reasons the program was first put into place and why it has continued to be reauthorized. Nothing has fundamentally altered this dynamic.

Similarly, it is not at all clear that scaling back the TRIA program would lead to more involvement in the market by private insurers. In fact, the opposite is likely true. Increasing the nominal amount of private-sector involvement in the current TRIA structure does not automatically translate into an increase in private-sector capital in the marketplace. Increased company retentions, co-shares, and an increased trigger level may cause market participants – particularly small- and medium-sized companies – to exit, thereby reducing total private capital. An effective terrorism loss management plan depends on participation by insurers of all sizes and structures.

UNDERSTANDING THE TRIGGER LEVEL

Consideration of just one proposed change is illustrative of this dynamic. It has been suggested that raising the event trigger level will further the goal of taxpayer protection. As a practical matter, however, a higher trigger would do nothing to reduce taxpayer exposure in the event of an attack.

The trigger level is the point at which insured losses are high enough to activate the TRIA program but does not ultimately determine the level that the program begins making initial outlays. In other words, there are scenarios in which the program is triggered and makes initial outlays for losses below the trigger level. Conversely there are scenarios in which the program is triggered and must make zero outlays.

First, consider a $200 million terrorist event involving a single, smaller insurer that writes approximately $200 million in TRIA-covered lines of business:

$200 M Event	**$200 M Trigger**
(Company deductible = $40 million)	
Program Triggered?	Yes
Insurer Losses (Deductible + Co-Share)	$72 M
Initial Government Outlays	$128 M
Mandatory Recoupment (Private-Sector Loss Sharing)	$179.2 M (140% X $128 M)
Net Gain/Loss to Fed. Government	**+ $51.2 M**

As you can see, in this specific scenario, despite the trigger level being set at $200 million, the TRIA program becomes involved after losses around $70 million. The way the TRIA program operates is based entirely on the specifics of the event and the insurance companies involved in the event.

Consider another $500 million scenario with a single impacted company with an individual retention level of $1 billion:

$500 M Event	**$200 M Trigger**	**$1 B Trigger**
(Company deductible = $1 billion)		
Program Triggered?	Yes	No
Insurer Losses (Deductible)	$500 M	$500 M
Initial Government Outlays* *Worst possible case	$0	$0
Mandatory Recoupment (Private-Sector Loss Sharing)	$0	$0
Net Gain/Loss to Fed. Government	**$0**	**$0**

Despite the program being triggered in one instance and not the other, the federal government does not make any initial outlays. Here, the trigger level has no impact. Where it does have a very significant impact is in cases involving smaller or regional insurers. Consider the same scenario for a single company with a retention level of $100 million:

$500 M Event	**$200 M Trigger**	**$1 B Trigger**
(Company deductible = $100 million)		
Program Triggered?	Yes	No
Insurer Losses (Deductible + Co-Share)	$180 M	$500 M
Initial Government Outlays	$320	$0
Mandatory Recoupment (Private-Sector Loss Sharing)	$448	$0
Net Gain/Loss to Fed. Government	**+ $128 M**	**$0**

While raising the trigger level does impact initial government outlays, we can see that ultimately, the cost to the taxpayer is not reduced. Furthermore, a $500 million loss could easily render such a company insolvent. Therefore, the only impact of raising the trigger would be on smaller, regional, and niche insurers whose deductible – and even total exposure – falls under a level set too high.

Potential exposure like this would cause these companies to pull out of markets. Because many of these smaller regional carriers play an important role in ensuring there is available coverages across lines of insurance, this would not just impact the terrorism risk insurance market but also the general insurance market. Because it is not at all clear that remaining companies could or would provide this missing coverage, the probable effect of a higher trigger would be to reduce competition by reducing the amount of total private capital allocated to all risks in certain areas.

In short, raising the trigger does nothing to reduce taxpayer exposure while simultaneously having the potential to drive private capital from the market.

WORKERS' COMPENSATION

Workers' compensation insurance is particularly challenging when it comes to terrorism risk. Workers' compensation writers are not permitted to exclude any peril from their coverages and are particularly susceptible to having highly concentrated losses in the event of a major terrorist attack. In the absence of a private-public risk-sharing mechanism, workers' compensation carriers will retreat from having highly concentrated losses in the event of a major attack. There would almost certainly be a simultaneous and significant increase in the cost of these policies and decrease in their availability for employers based in the major metropolitan areas and industries involved with, or adjacent to, symbols of America. The only way a workers' compensation writer could eliminate its terrorism exposure in high-risk markets would be to completely withdraw from those markets. In the absence of the TRIA program, or an increase in the deductibles and/or co-pays, we would expect to see a shift from the private workers' compensation writers to the insurer of last resort – usually a state fund or residual market pool, causing ripple effects throughout the business community. These public options for workers' compensation are not designed to handle a catastrophic terrorist event. Injured workers and their families would face potential disruption in benefits, delays in payment, or hardship because of the lack of an efficient compensation system.

Although individual market players may indicate willingness to take on greater exposure in the abstract, the private market has consistently demonstrated an unwillingness to accept a significantly larger portion of this potentially devastating risk, in particular when it comes to offering affordable limits to protect the solvency of workers' compensation insurers.

CONCLUSION

The TRIA program is a risk-sharing model between insurers, policyholders, and the federal government that – in addition to providing an immediate stabilizing effect in the short-term following a terrorist attack – has acted to create space for a robust private market for terrorism insurance to form where it would not have otherwise. With the TRIA program in place, the private sector has a tremendous amount of capital deployed in the terrorism risk insurance market, and, under current law, every penny the federal government pays out may be recovered. By all accounts, the TRIA program has been a tremendous success and should be reauthorized long-term without changes to the current structure.

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