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The Task Force on Federal Involvement in Insurance Regulation Modernization (the “Task Force”) has reviewed the newly-enacted terrorism insurance legislation, which extends the Terrorism Risk Insurance Act of 2002 (“TRIA” or “the Act”) and includes a provision mandating a study of the long-term issues involved in managing exposure to terrorism risk. As outlined below, the Task Force supports continuation of a public/private partnership to manage this exposure, and suggests changes to improve the ability of the partnership to achieve the intended purposes of the Act.

## **I. TRIA’s Successes, Coupled With Inability Of The Private Market To Manage This Risk Alone, Warrant A Continuation Of The Federal Program**

### **A. TRIA Has Supported The Availability Of Insurance**

Prior to the terrorist attacks on September 11, 2001, insurers considered terrorism such a low probability, low impact event that they did not charge any identifiable premium for terrorism coverage inherent in various property and casualty insurance.<sup>1</sup> The consequence was coverage for some \$32.4 billion in losses (out of a total of approximately \$80 billion) from the September 11 attacks.<sup>2</sup> Two-thirds of these losses were covered by reinsurance.<sup>3</sup> As a result of the dramatic shift in the perceived probability of a catastrophic terrorist loss, reinsurers immediately began to exclude coverage for terrorism.<sup>4</sup> Without access to reinsurance, many primary carriers also sought and obtained approval for endorsements to exclude coverage for terrorism.<sup>5</sup> As a consequence, terrorism coverage was more difficult to obtain after September 11. Nevertheless, insurance coverage broad enough to include terrorism was still

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<sup>1</sup> Robert P. Hartwig, *The Impact of the September 11 Attacks on the American Insurance Industry*, in INSURANCE AND SEPTEMBER 11 ONE YEAR AFTER: IMPACT, LESSONS AND UNRESOLVED ISSUES, at 10 (Patrick M. Liedtke & Christophe Courbage, eds., 2002).

<sup>2</sup> Robert P. Hartwig, “The Fate of TRIA: Is Terrorism an Insurance Risk?” (III 2004).

<sup>3</sup> *Terrorism Insurance: Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities: Testimony before the House Subcommittee on Oversight and Investigations, Committee on Financial Services*, 107th Cong. at 8 (Feb. 27, 2002) (statement of Richard J. Hillman, Director, Financial Markets and Community Investment), available at <http://www.gao.gov/new.items/d02472t.pdf> [hereinafter Hillman].

<sup>4</sup> See Hillman, *supra* note 3, at 4 (“Industry sources confirm that little reinsurance is being written today that includes coverage for terrorism.”); see also *Need for Federal Terror Insurance Assistance: Testimony before the House Subcommittee on Oversight and Investigation*, 2002 WL 2011117 (Feb. 27, 2002) (Testimony of Mark J. Warshawsky, Deputy Assistant Secretary for Economic Policy, U.S. Treasury) (noting that as of February 2002 “the reinsurance industry ha[d] almost entirely stopped assuming terrorism risk.”), available at <http://www.ustreas.gov/press/releases/po1050.htm> [hereinafter Warshawsky]

<sup>5</sup> By February 2002, terrorism exclusions for primary insurance had been approved in 45 states, the District of Columbia and Puerto Rico. See Hillman, *supra* note 3, at 5. The five states that have not approved the endorsement are California, Florida, Georgia, New York and Texas. See Hillman, *supra* note 2, at 17.

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required in various instances, and the reduced availability of terrorism insurance began to cause a “drag” on the U.S. economy.<sup>6</sup>

TRIA was adopted in response to these circumstances. It generally mandates that insurers offer terrorism insurance coverage to policyholders who purchase commercial property and casualty insurance covered by the Act.<sup>7</sup> It also provides a federal “backstop” through a pooling mechanism for terrorism risk, with the federal government standing behind that mechanism for up to a maximum of \$100 billion. After the adoption of TRIA, the price for terrorism insurance came down<sup>8</sup> and a greater number of policyholders purchased terrorism coverage.<sup>9</sup> According to a study conducted by Wharton Risk Management and Decision Processes Center at the University of Pennsylvania, “about 50% of commercial enterprises have purchased TRIA-line terrorism insurance.”<sup>10</sup>

Under the present market circumstances the availability of terrorism insurance would have decreased if TRIA had been permitted to expire.<sup>11</sup> Although reinsurers have re-entered the market for terrorism risk, reinsurers have only indicated a willingness to provide up to approximately \$5-6 billion in coverage<sup>12</sup>, which is only a fraction of the \$25 billion industry aggregate for program year four and is less than one-fourth of the estimated \$30 billion in individual insurer retentions. Survey data shows that reinsurers are not likely to significantly

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<sup>6</sup> See Joint Economic Committee of the U.S. Congress, *Economic Perspectives on Terrorism Insurance* (2002) (available from the Government Printing Office); see also Hartwig, *supra* note 1, at 28-29; Hillman, *supra* note 3, at 9.

<sup>7</sup> See Terrorism Risk Insurance Act of 2002 § 103(c), Public Law No. 107-297, 116 Stat. 2322.

<sup>8</sup> See PETER CHALK, BRUCE HOFFMAN, ROBERT REVILLE, ANNA-BRITT KASUPSKI, TRENDS IN TERRORISM: THREATS TO THE UNITED STATES AND THE FUTURE OF THE TERRORISM RISK INSURANCE ACT at 7 (2005) (citing the Congressional Budget Office and others) [hereinafter RAND]:

During the first nine months of 2002, for instance, rates for property coverage declined by an average of between 50 to 75 percent and since 2003 have continued to fall by roughly one-half. In the third quarter of 2004, the typical price for terrorism insurance represented around 4 percent of the total premium for property coverage, compared to 10 percent in the third quarter of 2003.

<sup>9</sup> See RAND, *supra* note 8, at 7-8 (citing Congressional Budget Office and others):

It is not surprising that as prices have fallen, the fraction of companies that purchase terrorism coverage (or “take-up rates”) have increased. One study undertaken by Marsh Inc. in 2004, for instance, showed that 44 percent of large companies bought terrorism coverage in the third quarter of 2004, compared with only 26 percent for the same period the previous year. Another survey by Aon produced figures of 57 percent (2004) versus 24 percent (2003). The take-up rates vary somewhat depending on the region and industry, with higher take-up rates in the Eastern and Midwestern United States (58 percent and 60 percent, respectively, according to Marsh) than in the South and West (29 and 38 percent, respectively).

<sup>10</sup> WHARTON RISK MANAGEMENT AND DECISION PROCESS CENTER, TRIA AND BEYOND, at 2 (2005) [hereinafter WHARTON]; see also RAND *supra* note 9. The Wharton study conducted a survey of the National Association of Real Estate Investment Trusts and did an analysis of Aon data. The report analyzes this data in chapter nine, see WHARTON, *supra*, at 165-180. The NAREIT survey showed that between 85.5% and 93.5% of property held by survey respondents was covered by terrorism insurance. *Id.* at 167. The Aon data was analyzed using a statistical model to show take-up rates by industry, region and firm size. These rates range from 0% purchases of terrorism coverage for construction in the central region to 100% for transportation in the western region. See *id.* at 172.

<sup>11</sup> See RAND, *supra* note 8, at 9; see also WHARTON, *supra* note 10, at 168 (noting that survey respondents from the National Association of Real Estate Investment Trusts reported “significant negative repercussions from non-renewal” of TRIA including loan defaults, difficulty in refinancing, and going without terrorism insurance).

<sup>12</sup> See WHARTON, *supra* note 10, at 27 (survey response citing RAA study).

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increase the coverage available for terrorism.<sup>13</sup> Without access to reinsurance or TRIA, if actions post-September 11 are any guide, many primary insurers would take actions to avoid underwriting terrorism risk.<sup>14</sup>

### **B. Terrorism Is Uniquely Difficult To Assess**

Terrorism has characteristics that, taken together, make it significantly more difficult to predict and model than other kinds of risks. Terrorism is perpetrated by human actors who have the intention of causing harm.<sup>15</sup> In order to generate greater fear and alarm,<sup>16</sup> terrorists may act in ways that are unexpected.<sup>17</sup> Although terrorists have sometimes attacked “hard” targets in the past because of their symbolic significance, terrorists are showing an increased willingness to attack “soft” targets with significant civilian exposures.<sup>18</sup> The religious or political fervor of some terrorists and their willingness to commit suicide is another consideration that makes it difficult to model or prevent terrorist behavior.<sup>19</sup>

The challenge of modeling terrorist behavior is compounded by a lack of information. The historical data available on terrorism are limited because of a relatively few number of incidents, and the utility of the available data for those incidents is limited by the wide variety of cultural and operational contexts within which the events took place.<sup>20</sup> In addition, although much of the focus has been on al Qaeda after September 11, there are various terrorist organizations that have substantial differences in ideology, structure and methodology.<sup>21</sup>

Moreover, much of the information about terrorism risk has been collected by governmental agencies, which are understandably unwilling to share that information because of national security and law enforcement concerns.<sup>22</sup> The government also has a role in affecting the nature and scope of the risk through anti-terrorism and other policies.<sup>23</sup> The government, the Federal government in particular, devotes substantial resources to combating terrorism, which may reduce or increase the risk of terrorism, or may have an impact on certain kinds of risks or risks in specific geographical areas. Because the risk of terrorism is a national security concern,

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<sup>13</sup> See WHARTON, *supra* note 10, Appendix 1A, at 27-28.

<sup>14</sup> See U.S. DEPARTMENT OF TREASURY, ASSESSMENT: THE TERRORISM RISK INSURANCE ACT OF 2002, at 6 (2005) (nearly 50% of insurers responding to a treasury survey said that they do not plan to write terrorism coverage after TRIA expires; 25% of policyholders indicated that their current terrorist coverage excludes coverage after the expiration of TRIA) [Hereinafter TREASURY REPORT].

<sup>15</sup> See WHARTON, *supra* note 10, at 13.

<sup>16</sup> See WHARTON, *supra* note 10, at 13.

<sup>17</sup> This been described as the dynamic uncertainty problem. See WHARTON, *supra* note 10, at 52-53.

<sup>18</sup> See RAND, *supra* note 8, at 15-16; see also See WHARTON, *supra* note 10, at 13, 52, 56.

<sup>19</sup> See RAND, *supra* note 8, at 26-29 (describing use of suicide attacks by al Qaeda); see also WHARTON, *supra* note 10, at 55-56.

<sup>20</sup> See WHARTON, *supra* note 10, at 58.

<sup>21</sup> The main threat to the U.S. is considered to be al Qaeda, but many terrorist events have been undertaken by other organizations that have largely limited their activities to local targets. See RAND, *supra* note 8, at 11 n.1. In addition, there is a growing risk of home-grown terrorism in the U.S. from both the left (the anti-globalization and radical environmental groups) and the far right. See *id* at 39-51.

<sup>22</sup> See WHARTON, *supra* note 10, at 53-54.

<sup>23</sup> See WHARTON, *supra* note 10, at 54.

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a terrorist attack often can be interpreted as an attack on the country as a whole even though the attack may be harmful to many.

Another characteristic of terrorism risk is the variability of its impact. While much progress has been made in modeling the consequences of a terrorist attack,<sup>24</sup> even with these models there are many different impact scenarios.<sup>25</sup> Although certain areas tend to present greater risk of terrorism, it is impossible to rule out any potential target. As some targets become more difficult to attack, it is possible that terrorists could switch to easier targets in less-protected locations. Nuclear, biological, chemical or radiological attacks could affect very large geographic areas and potentially millions of people,<sup>26</sup> while attacks with conventional weapons could be limited to a single business or individual. Some terrorist activity appears to be specifically aimed at the U.S. economy,<sup>27</sup> which presents the possibility of attacks in more remote areas.<sup>28</sup>

Taken together, these characteristics make terrorism very different from other kinds of risks and pose significant challenges for underwriting.<sup>29</sup> The risk is so variable and difficult to predict that insurers and reinsurers are cautious about taking on that risk. In addition, because the size of the risk is so variable, it is hard to determine the amount of capital reserves that should be maintained for that risk.<sup>30</sup> Whatever those reserves, capital maintained for terrorism risk has an impact on other risks because that capital cannot be used to underwrite other, non-terrorism risks. By providing a source of capital for payment of claims in the case of a catastrophic terrorist attack, TRIA frees up some capital and reduces the exposure for insurers to a level that provides an opportunity for the market to function.

Because of the unpredictability of a terrorist attack and the amount of losses caused by such an attack, insurers who plan for the worst have an incentive to not insure terrorism events or to charge a high premium to reflect the unpredictability of a terrorism event.<sup>31</sup> TRIA, by reducing the amount of risk to be borne by insurers, has helped stabilize the price for terrorism insurance.<sup>32</sup> Without a federal backstop, it is expected that prices for terrorism insurance would increase.<sup>33</sup> From a theoretical standpoint, larger and more uncertain risks generally have higher prices reflecting the greater risk, so it is not surprising that terrorism insurance would be

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<sup>24</sup> See WHARTON, *supra* note 10, at 59-61.

<sup>25</sup> See WHARTON, *supra* note 10, at 62, 65.

<sup>26</sup> Al Qaeda has an ongoing interest in acquiring and using such weapons. See RAND, *supra* note 8, at 30-31. The implications for the economy could be disastrous. See *id.* at 36-37. For a more general description of potential catastrophic scenarios, see WHARTON, *supra* note 10, at 50-51.

<sup>27</sup> See RAND, *supra* note 8, at 21-23

<sup>28</sup> See RAND, *supra* note 8, at 22 (noting examples of oil installations, seaports and shipping).

<sup>29</sup> See WHARTON, *supra* note 10, Chapter 3.2.

<sup>30</sup> See WHARTON, *supra* note 10, at 49.

<sup>31</sup> In more technical terms, an underwriter setting the price for insurance considers the “probable maximal loss.” In light of the September 11<sup>th</sup> attack, the probable maximal loss for a terrorist attack can be billions of dollars. Insurers want to charge fairly high premiums to take on such a large risk. TRIA, by providing a reimbursement mechanism for large terrorism losses, reduces the probable maximal loss and thereby encourages a lower price.

<sup>32</sup> See *supra* note 8.

<sup>33</sup> See RAND, *supra* note 8, at 9; WHARTON, *supra* note 10, Appendix 1A, at 28.

expensive.<sup>34</sup> Competition, in theory, provides an incentive to lower prices, but even competitive pricing for risks with high levels of unpredictability are likely to reflect a higher premium for the high risk.<sup>35</sup>

### **C. TRIA Supports A Market Mechanism For Terrorism Insurance**

By providing a backstop for catastrophic terrorism risk, TRIA improves the ability of the market to respond to this risk. One of TRIA's primary functions is to provide access to funds to pay claims in the event of a catastrophic loss. In the first year of the program, TRIA provided that the Federal government would provide payments to participating insurers for insured terrorism losses in excess of 7% of a company's prior year direct earned premiums for covered lines. The individual retention for insurers was raised to 10% of prior year direct earned premiums for the second year, and then to 15% in the third year. The extended version of TRIA increases insurer retention to 17.5% in 2006 and then to 20% in 2007, but retains backstop protection up to the \$100 billion limit. While some or perhaps much of any payments made under TRIA would be recouped through discretionary post-event surcharges, the availability of federal funds reduces the catastrophic front-end risk to insurers. This makes market forces have greater capability to function for the remaining risk. Because the catastrophic risk is backstopped by the Federal government and would be spread to the industry through the TRIA mechanism, insurers may be more willing to put their capital at risk while still maintaining capital for other kinds of risks (such as natural disasters).<sup>36</sup> As a result, with TRIA, more capital is available in the market for terrorism insurance.

TRIA also supports the affordability of terrorism insurance in the market. By reducing the amount of front-end capital at risk, insurers have greater capacity to offer terrorism insurance at lower prices. In addition, while TRIA does not mandate the price for terrorism coverage, it does require that participating insurers offer such coverage. The combination of a reduction in an insurer's capital at risk, the requirement of mandatory offering, and competition to satisfy policyholders who were purchasing property and other insurance products, encouraged lower prices for terrorism insurance. Studies show that prices for terrorism insurance decreased after the adoption of TRIA.<sup>37</sup>

By improving availability of terrorism insurance, TRIA has encouraged pre-event planning rather than reliance on after-event ad hoc governmental assistance for victims. Insurance offered before an event creates an opportunity for risk assessment and management, and market forces create an incentive to take advantage of such opportunities. On the other hand, a mechanism that operates primarily after the event, such as government aid for victims of terrorism, may work against market incentives. If potential victims rely on the government to provide aid after the fact, they may not have incentives to assess and manage their risks. The government, as the provider of the assistance, has an incentive, of course, but the result and a

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<sup>34</sup> See WHARTON, *supra* note 10, at 35-36.

<sup>35</sup> See *id.* at 87.

<sup>36</sup> For a historical summary of property losses from natural catastrophes and made-made disasters, including September 11<sup>th</sup> attack, See WHARTON, *supra* note 10, at 46-48.

<sup>37</sup> See *supra* note 8.

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post-event system is reliance on governmental risk assessment and management instead of the market. By encouraging availability and use of terrorism insurance, TRIA provides opportunities to use market incentives for assessing and managing terrorism risk.

## **II. Improvements To Better Meet The Purposes Of TRIA**

TRIA has been beneficial in making terrorism insurance more available, and we agree with the Congressional decision to extend the law. As the President's Working Group on Financial Markets, the National Association of Insurance Commissioners, and others study whether the government-industry partnership should be continued beyond 2007, the Task Force makes the following recommendations to improve the ability to meet the intended purposes of TRIA.

### **A. State Regulation Of The Price Of Terrorism Insurance Should Be Preempted**

TRIA is designed to provide support for the market mechanism, not to displace it. One of the primary characteristics of a market mechanism is the ability to change prices according to market circumstances. In recognition of this principle, TRIA did not set a price for terrorism insurance. At the same time, however, TRIA did not completely preempt the state regulation of insurance premium rates. Instead, for the first year TRIA preempted the states' prior approval of rates (and any applicable "waiting period), but allowed states to invalidate rates as excessive, inadequate, or unfairly discriminatory on subsequent review of the rate.<sup>38</sup> Thus, while federal law did not regulate pricing of terrorism insurance, state regulations continued to apply.<sup>39</sup> Some states used regulatory authority to lower the price requested by insurers,<sup>40</sup> while others used their regulatory power to negotiate adjustments to the proposed pricing model.<sup>41</sup>

Although lower rates in some states may improve access and the willingness of policyholders to buy terrorism coverage, they create inequity from state to state. For example, suppose that state A permits pricing at 30% of an appropriate premium, while state B allows a premium at 100%.<sup>42</sup> This is inequitable because companies in state A would be forced to bear the same or even higher terrorism risk for premiums that are lower than what was approved in state B. In

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<sup>38</sup> See Terrorism Risk Insurance Act of 2002 § 106(a)(2)(B), Public Law No. 107-297, 116 Stat. 2322.

<sup>39</sup> See WHARTON, *supra* note 10, at 84-85 (workers compensation) and at 87-88 (commercial property).

<sup>40</sup> The AIA reported that New York, District of Columbia, Florida, Georgia, Louisiana, and North Carolina "negotiated" downward from the rates proposed by the Insurance Services Office. American Insurance Association, *How the Free Market Fails for Terrorism Insurance* (April 2005). The District of Columbia also approved rates below the recommended model for workers compensation. See WHARTON, *supra* note 10, at 84.

<sup>41</sup> See WHARTON, *supra* note 10, at 88. Although most states accepted the proposed model for pricing of workers compensation insurance, the regulatory structure makes it difficult to differentiate between employers based on the terrorism risk, which resulted in pricing that may have been too high or too low for the individual employer. See *id.* at 84-85.

<sup>42</sup> The Insurance Services Office developed a methodology to price terrorism risk, and suggested that a price of \$0.10 per \$100 of value for property coverage would be appropriate in high risk cities. Regulators in New York and District of Columbia, however, approved \$0.03 and \$0.018, depending on the property. See American Insurance Association, *How the Free Market Fails* (April 2005). Other states have taken other approaches that have kept down the rates for terrorism insurance. See *id.* Regulators have taken a similar approach to the suggested pricing model developed for workers compensation coverage. See *id.* None of the states has adopted pricing at the level that was suggested by the Insurance Services Office. See WHARTON, *supra* note 10, at 88.

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addition, if the same company does business in both states, it might seek approval for even higher premium in state B to make up for the artificially low premium in state A.<sup>43</sup>

This rating regulation also makes it more difficult for insurers to charge an appropriate premium. Theoretically, the premium charged for any particular risk should reflect the level of that risk. If approved premiums are artificially too low, then insurers are less able to develop the capital necessary to pay claims in the event of an insured loss.

Another consequence of state pricing regulation is that it interferes with the development of the reinsurance market. When state regulators require that premiums be less than the market price, insurers find it more difficult to purchase reinsurance, which is subject to no price regulation and therefore reflects the market price. Where the primary insurance is priced below market, insurers may not be able to afford reinsurance. There is some evidence that the pricing for primary terrorism coverage is interfering with development of the reinsurance market. The Wharton study found that “there is relatively little private insurance to cover portions of losses below the TRIA deductible in urban areas and/or the price of reinsurance is prohibitively high relative to the premium that insurers can charge for coverage to commercial firms.”<sup>44</sup>

State price regulation also reduces the flexibility of terrorism insurance pricing, which reduces the ability to use market incentives for risk assessment and management.<sup>45</sup> Market pricing allows differentials for efforts to mitigate or reduce various risks. Although regulated prices can also recognize such differentials, it is difficult to develop such differentials if regulation makes prices artificially low. In addition, it can be difficult and time consuming to get approval for price differentials, which makes them more cumbersome and less responsive to the market forces.

The preemption of state regulation for terrorism insurance could solve this problem in one of two different ways. On one hand, federal law could preempt state regulation and allow the market to set the price by mandating a form of notice filing. Although this would allow higher prices at least initially in some states, competition would reduce those prices to some extent. In addition, because terrorism coverage is typically an additional coverage rather than a stand-alone product, competition will be intensified by companies’ efforts to keep the main line of business by having stable prices for the terrorism addition.

The second possible solution would be for federal law to set a national price for terrorism. This would address the equity problem from state to state and would also allow the government to set a price low enough to encourage access but high enough to address the risk of insolvency associated with a terrorism loss. A single national price, however, would create fairness

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<sup>43</sup> This inequality may be magnified after a terrorism event by the operation of the post-event recoupment surcharges. The surcharges as total premiums, which would include the portion for terrorism, so policyholders in state A in the example would pay a lower surcharge than that paid by policyholders in state B. The inequity of this distribution would be especially unfair if the terrorist event was only in state A, in which case the higher surcharges in state B would subsidize the payment of benefits to insurers in state A.

<sup>44</sup> See WHARTON, *supra* note 10, at 19-20.

<sup>45</sup> See WHARTON, *supra* note 10, at 84-85 (describing the lack of flexibility for workers compensation pricing).

problems from state to state where the risk of terrorism differed. Policyholders in low-risk states may choose not to buy terrorism coverage if the price is too high, and policyholders in high risk states may not pay enough for the coverage. Such state and regional differences also may unfairly impact insurers because the nationally-set price may not reflect differing geographic risks and other market considerations. This problem could be addressed to some extent with a national pricing system that would have several different prices based on the level of risk involved,<sup>46</sup> but that may require use of a federal regulatory infrastructure for rate-setting. In addition, this solution would not take advantage of competitive free market forces.

### **B. State Mandated Coverage For Fire Damage That Ensues From A Terrorist Event Under The Standard Fire Insurance Policy Should Be Preempted**

Another form of state regulation that interferes with the ability of market forces to function for terrorism insurance is the requirement for ensuing fire coverage. At the time of the September 11<sup>th</sup> attacks, 29 states required commercial property insurance to conform to the coverage of the so-called “standard fire insurance policy.”<sup>47</sup> This requirement mandates that property insurance provide coverage for fires that ensue from a terrorist event even if other damages from the terrorist events are specifically excluded by the policy.<sup>48</sup> After TRIA was adopted, twelve states modified their statutes to exclude in various ways ensuing fire coverage caused by acts of terrorism.<sup>49</sup> This leaves ensuing fire coverage for terrorism events mandated in 17 states.

Such mandated coverage raises concerns similar to those of pricing regulation. Insurers in states with the mandate are forced to provide terrorism coverage.<sup>50</sup> This means that those carriers may be at a comparative disadvantage to those selling insurance in other states where terrorism coverage is more easily priced separately. This raises the same problems as explained above: it is inequitable to insurance carriers because some may be more able to collect a premium for terrorism coverage compared to others; it reduces the ability of insurers to buy reinsurance for the terrorism risk mandated by the ensuing fire provisions; and it limits the flexibility of insurance pricing which reduces the effectiveness of market incentives for risk management.

The solution for this problem recommended by the Task Force is to have TRIA preempt those state laws that require coverage for fire losses that ensue from a terrorist event. This would allow insurers to offer and separately price terrorism coverage, which will allow the market incentives to function.

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<sup>46</sup> The pricing structure recommended by the Insurance Services Office suggested three levels of pricing. See WHARTON, *supra* note 10, at 88.

<sup>47</sup> See WHARTON, *supra* note 10, at 85.

<sup>48</sup> See, e.g., Opinion Regarding Commercial Property Insurance Terrorism Limitation for Fire Following, General Counsel, New York State Insurance Department, June 26, 2003, available at <http://www.ins.state.ny.us/rg030627.htm> [last visited Nov. 4, 2005].

<sup>49</sup> See WHARTON, *supra* note 10, at 85. Amendments are under consideration in additional states. *Id.*

<sup>50</sup> Theoretically, insurers could ask regulators to approve a higher premium for property insurance that covers fires that ensue from terrorism, but the burden of demonstrating the basis for the increase is so great that insurers are unlikely to seek or obtain approval for such increases.

### C. Scope Of Lines Of Insurance Covered

During the debates about the extension of TRIA there was much discussion of the scope of the lines of insurance that were to be included within the scope of the Act's coverage. The Task Force recognizes that differences in the lines of insurance and the way that terrorism impacts certain lines may warrant different treatment under a government-industry partnership providing a backstop for terrorism coverage. TRIA initially covered commercial property & casualty insurance, including workers compensation and automobile coverage. Health and life insurance, including group life, were not covered. Although some proposals recommended significant changes in the lines covered by statute, the extension of TRIA made relatively minor changes. Commercial automobile, burglary and theft, surety coverage, professional liability, and farm owners multiple peril insurance were excluded from coverage in the extended version of TRIA, and directors and officers liability was specifically included. Health and life insurance, including group life, continued to be outside the scope of TRIA.

While the extended version of TRIA did not significantly alter the scope of coverage for lines of insurance, the Task Force provides some analysis of this issue to help identify considerations that may help prioritize which lines of insurance may be included in any future government-industry partnership. The Task Force suggests that justification for inclusion of a line of insurance should be evaluated in terms of the level of exposure to terrorism risk, the potential impact of a terrorism loss, and the limitations on marketplace flexibility for that line of insurance. In the discussion that follows, we begin generally with those lines of insurance with the strongest justification for inclusion.

The Task Force does not make a specific recommendation as to where the line of inclusion or exclusion should be drawn. The Task Force, however, notes that wherever the line is drawn, the level of industry retention should be determined with reference to the capital availability of the lines of insurance covered by any government-industry partnership. In other words, if the scope of coverage for insurers is narrowed in the future, the industry retention should be reduced.

#### 1. *Workers Compensation*

The mandatory nature of workers compensation coverage provides a strong justification for its ongoing inclusion in any government-industry partnership providing a terrorism insurance backstop. Workers compensation carriers are not allowed to exclude terrorism coverage.<sup>51</sup> As a result, a terrorist attack could have a major impact on that segment of the industry. The September 11<sup>th</sup> attack had a significant impact, amounting to \$1.8 billion.<sup>52</sup> That exposure could be as much as \$90 billion in the event of a major nuclear, chemical, biological or

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<sup>51</sup> See WHARTON, *supra* note 10, at 81 (noting that workers compensation insurance "is mandatory for a large majority of employers in all states except Texas where it is optional").

<sup>52</sup> See TREASURY REPORT at 26, Figure 2.9 (relying on data from the Insurance Information Institute).

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radiological attack.<sup>53</sup> Even a conventional five-ton bomb used against a single building in New York could cause more than \$7 billion in workers compensation losses.<sup>54</sup> Because there is only about \$30 billion of capital available in workers compensation insurance,<sup>55</sup> a major attack could substantially deplete or even exceed the available capital.<sup>56</sup> Moreover, because only a few key insurers provide workers compensation coverage in states such as California and New York, “some insurers in these states are likely to be declared insolvent after a large terrorist attack.”<sup>57</sup> The need for workers to have available financial support in the event of injury on the job is no less when the injury stems from the negligence of employers or from a terrorist attack.

## 2. *Commercial Property*

Availability of commercial property insurance<sup>58</sup> was a primary concern motivating the passage of TRIA in the first instance. Many lenders were hesitant to lend on projects without commercial property coverage for terrorism, which created a “drag” on the economy.<sup>59</sup> The nature of terrorism risk has a significant connection to commercial property, which represents a significant accumulation of assets – physical and economic – in the U.S. economy. Commercial property continues to be a significant terrorist target,<sup>60</sup> and, to the extent that the U.S. economy has become a significant target, terrorism represents a significant risk for business interruption insurance. The September 11<sup>th</sup> attacks resulted in \$20.6 billion in insured property losses, including \$11 billion in business interruption losses (that could grow as litigation is resolved).<sup>61</sup>

Because of the size of assets involved and the significant risk for commercial property, insurers may be hesitant to underwrite such risks without the TRIA backstop or commercial reinsurance.<sup>62</sup> As explained above, the reinsurance market is not likely to provide coverage even for the industry retention of TRIA, let alone the full amount of the commercial risk of a terrorism attack.<sup>63</sup> Therefore, continuing a government-industry partnership after the

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<sup>53</sup> See WHARTON, *supra* note 10, at 50; see also Towers Perrin, *Workers Compensation Terrorism Reinsurance Pool Feasibility Study: Summary of Study Findings and Conclusions* (March 2004) (available at [http://www.towersperrin.com/tillinghast/publications/reports/WC\\_Terr\\_Pool/WC\\_Terr\\_Pool\\_Study\\_ES.pdf](http://www.towersperrin.com/tillinghast/publications/reports/WC_Terr_Pool/WC_Terr_Pool_Study_ES.pdf)) [last visited Nov. 4, 2005].

<sup>54</sup> See *id.* at 99, Figure 6.4.

<sup>55</sup> See Towers Perrin, *supra* note 62.

<sup>56</sup> See *id.*

<sup>57</sup> See WHARTON, *supra* note 10, at 113.

<sup>58</sup> Commercial property insurance includes various kinds of property insurance, including builders risk and inland marine. Availability of such insurance can be very important to the economy.

<sup>59</sup> See *supra* note 6.

<sup>60</sup> See *supra* note 27.

<sup>61</sup> These figures are as of October 2004 and presume that the jury verdict finding that the World Trade Center loss was due to two occurrences, and therefore resulted in a \$3.6 billion property claim. See TREASURY REPORT at 26, Figure 2.9 (relying on data from the Insurance Information Institute).

<sup>62</sup> See *supra* notes 4 & 5.

<sup>63</sup> See *supra* note 26 & 27, and accompanying text.

expiration of TRIA in 2007 is essential to continued accessibility to commercial property insurance.<sup>64</sup>

### *3. Commercial Liability*

Commercial liability insurance faces significant exposure from a terrorist attack. Although the Victim's Compensation Fund<sup>65</sup> resulted in many claimants waiving liability claims, and thus reduced liability exposures for policyholders, it provides some sense of the amount at stake. The Fund paid out approximately \$7 billion in damages,<sup>66</sup> and using an expense ratio of 33%, the total exposure for a September 11-like event can be estimated as something more than \$9 billion. When this figure is added to the estimated \$4 billion in general liability insured losses from the September 11<sup>th</sup> attack,<sup>67</sup> the total is \$13 billion. While this is a significant amount, it is significantly less than the \$20.6 billion in insured property losses from the September 11<sup>th</sup> attacks. Of course, because commercial liability losses depend on the outcome of litigation, the full extent of September 11<sup>th</sup> losses may not be known for some period of time.

Although commercial liability insurance faces a serious terrorism risk, liability insurance, which is often referred to as third-party insurance, is significantly different from property or workers compensation insurance. Unlike property or workers compensation insurance (known as "first-party" insurance), liability insurance generally requires that the claimant establish that the policyholder is legally obligated to pay the claim. Typically, the claimant must demonstrate that his or her injuries were caused by the policyholder's negligence. This requirement generally makes the liability policyholder (as tortfeasor) more culpable than the policyholder of property or workers compensation insurance. As a result, it may be more appropriate for the tortfeasor to bear the consequences of the terrorist attack than a policyholder who was not negligent. In addition, by bringing the third-party (tortfeasor) into the equation, the tort system creates its own pooling effect independent of insurance. The resources of the tortfeasor (which may not have suffered any direct losses from a terrorist attack) are made available to compensate the claimant, and where there are multiple defendants (which is not uncommon), the pool of resources is broadened even further. Because it is so difficult to predict who will be a defendant (thereby subjected to litigation expenses) and which, if any, of the defendants will be held liable following a terrorist attack, it is difficult to calculate the terrorism risk for liability insurance.

It should be pointed out that relying on tortfeasor resources independent of liability insurance for terrorism could have a negative effect on the economy by reducing resources available for investment and by possibly forcing some tortfeasors into bankruptcy. Liability insurance is

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<sup>64</sup> See Robert P. Hartwig, Gordon Stewart & Claire Wilkinson, *Terrorism, Insurance and the United States Government* (Sept. 2004)[see [http://server.iii.org/yy\\_obj\\_data/binary/741171\\_1\\_0/TerrorismInsurance.pdf](http://server.iii.org/yy_obj_data/binary/741171_1_0/TerrorismInsurance.pdf)] (last visited Nov. 1, 2005).

<sup>65</sup> The legislation creating the Victims Compensation Fund was signed into law on September 22, 2001, as the Air Transportation Safety and System Stabilization Act of 2001, Pub. L. No. 107-42, 115 Stat. 230 (2001). See 49 USC § 40101.

<sup>66</sup> See WHARTON, *supra* note 10, at 45 (citing the Congressional Budget Office study).

<sup>67</sup> See WHARTON, *supra* note 10, at 44, Figure 3.1.

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meant to pool the risk of such liability losses so as to preserve the policyholder's resources and may be considered evidence of responsible management. Liability insurance also functions to ensure that the injured are compensated. This compensation is provided through a private market mechanism that can reduce the need for compensation through government programs funded by taxes. As a result, availability of liability insurance for terrorism would help compensate victims and may mitigate the catastrophic impact on individual companies found to be negligent, thereby providing some assistance to the economy. But a negligent company is much different than a property owner (or lender) or an employer, which may be a more "innocent" victim of terrorism.

Another difference with commercial liability insurance is that tort reform measures may provide some protection against excessive exposure for terrorism liability. Measures, either those already under consideration or those being considered for terrorism risks, such as limits on punitive damages, damages caps, or consolidation of claims, may reduce liability risk from a terrorist attack sufficiently that they can be handled by current insurance mechanisms.

Nevertheless, the unpredictability of terrorism and the undeveloped tort law as to what constitutes reasonable care to avoid or mitigate a terrorist attack make it difficult to assess the level of risk for liability insurers. As a result, it is possible that a major terrorist attack could present potential liability well in excess of the \$13 billion represented by the September 11<sup>th</sup> attacks. Such losses could represent a serious threat to the solvency of insurers.<sup>68</sup>

#### 4. *Group Life, Disability, Accident and Health*

Terrorism risk is significant for group life, disability, accident and health insurance.<sup>69</sup> The September 11<sup>th</sup> attack generated \$1 billion in losses for life insurers.<sup>70</sup> A nuclear, chemical, biological or radiological attack could substantially increase such losses.<sup>71</sup> In addition, because group life insurance policies are sold to groups of employees, they present a concentrated risk that could magnify the impact of a terrorist attack for a single carrier. For example, a group life insurance policy may be sold to a company with the underwriting expectation that just a few people will die in any given year. A terrorist attack, however, could dramatically alter that

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<sup>68</sup> The studies have not focused on the risks for liability insurers in particular. However, an analysis by the NAIC shortly after September 11<sup>th</sup> found that losses in excess of \$25 million borne by a single property-casualty insurer would threaten the solvency of 886 insurers representing 44% of the insurers writing commercial property-casualty insurance. See Hillman, *supra* note 3, at 16-17.

<sup>69</sup> See WHARTON, *supra* note 10, at 44 (noting that because of the high degree of risk correlation in the different lines of insurance the September 11<sup>th</sup> attacks led to significant claims from other lines of insurance including life, health and disability).

<sup>70</sup> See WHARTON, *supra* note 10, at 44, Figure 3.1. Of that total, it is estimated that something less than 50% was borne by group life insurance. *Id.*

<sup>71</sup> Although we have not seen estimate models specific to these lines of insurance, some models have shown workers compensation losses to be as high as \$90 billion. See *supra* note 62. While workers compensation losses are not identical to group life, disability, accident and health, they provide some similar coverage (though without requiring the connection to one's employment), so it is reasonable to assume that a major terrorist attack could cause tens of billions of dollars in damages for life, disability, accident and health insurance.

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risk so that hundreds or even thousands of people in the group would die at the same time.<sup>72</sup> Because of the significant risk, the difficulty in predicting terrorism, and the concentration of that risk with large insurers, it may be appropriate to include these lines of insurance in TRIA.

Group life, disability, accident and health insurance all service an important public interest of providing resources to sick and injured individuals, their families, and the survivors of those who die. Because such resources are provided through a private market mechanism, the availability of such insurance helps to reduce the demands on government programs, funded through taxes, that may otherwise be called upon to provide support.

While the level of risk is significant for these kinds of insurance, the Treasury Department chose not to include group life insurance in TRIA because it found that group life insurers continued to offer insurance after the September 11<sup>th</sup> attacks.<sup>73</sup> Thus, it may be that the risk to these lines of insurance is not so high as to create difficulty in providing sufficient capital to underwrite the risk.

#### *5. Auto and Homeowners*

Although terrorism is a significant risk for auto and homeowners insurance,<sup>74</sup> as evidenced by the September 11<sup>th</sup> attacks, TRIA was not extended to these lines of insurance. Because of the nature of terrorism, however, and the risk that an even larger loss might be caused by terrorism in the future, one can argue that these lines should also be included in the coverage in the future. But unlike group life discussed above, auto and homeowners insurers tend to avoid the concentration of losses. Although a large number of cars or homes might be damaged by a terrorist attack, the distribution of the insurance losses from the damage to those properties is likely to be more random. In addition, while there were losses in these lines associated with the September 11<sup>th</sup> attacks, they have not been calculated separately, and therefore may not be of a sufficient size to warrant including these lines of insurance in TRIA coverage. On the other hand, consideration should be given to inclusion of personal property-casualty insurance lines such as auto or homeowners in a federal terrorism insurance program where the nature of the event (i.e., a NBCR-type event) is likely to trigger substantial losses in those lines.

#### **D. The Scope of Coverage Should Include Domestic Terrorism**

By the statutory definition of terrorism in TRIA, domestic terrorism is excluded from the scope of coverage.<sup>75</sup> This was not changed when TRIA was extended. Although limiting coverage reduces the program's financial exposure, distinguishing between domestic and international

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<sup>72</sup> See Testimony of the NAIC before the Senate Committee on Banking, Housing and Urban Affairs (April 14, 2005) (testimony provided by Howard Mills, Acting Superintendent of Insurance for New York) (available at <http://www.ins.state.ny.us/acrobat/sp050414.pdf>) [last visited November 4, 2005].

<sup>73</sup> See WHARTON, *supra* note 10, at 17 n.12.

<sup>74</sup> See WHARTON, *supra* note 10, at 16-17.

<sup>75</sup> See Terrorism Risk Insurance Act § 102(1)(A)(iv), Public Law No. 107-297, 116 Stat. 2322. This has created a sizable coverage gap for domestic terrorism. Although some insurers are selling domestic coverage without TRIA support, the take-up rates are significantly lower and will continue to lag behind coverage that is included in TRIA. See RAND, *supra* note 8, at 53.

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terrorism for purposes of a federal backstop for insurance is not justified and the boundaries of this distinction are elusive.<sup>76</sup> Domestic terrorism has many of the same characteristics as international terrorism and therefore presents similar challenges for insurers trying to underwrite it. Although September 11<sup>th</sup> was an incident of international terrorism, the Oklahoma bombing, a domestic incident, was the second or third most damaging terrorist incident in the United States.<sup>77</sup> Domestic terrorism continues to be a serious threat.<sup>78</sup>

Moreover, determining whether an event meets the TRIA definition of terrorism may be difficult,<sup>79</sup> as shown by both the anthrax incidents in 2001 and the London bombings this past summer. The culprits of the anthrax incidents have not been identified. As a result, we do not know whether the culprits had a sufficient relationship to an international terrorist organization to satisfy the TRIA definition.<sup>80</sup> Similarly, although the culprits of the London bombings have been identified as British citizens apparently sympathetic to al Qaeda, it is unclear whether this connection is direct enough to satisfy the definition.

Because domestic terrorism is not included in TRIA coverage, insurers are not required to offer insurance for domestic terrorism. As a result, domestic terrorism insurance coverage is generally unavailable in the voluntary insurance market. Although this may reduce potential costs of the TRIA program, it creates a significant coverage gap leaving policyholders with no insurance coverage for events not linked to international terrorist activity. This gap is complicated by the difficulty in determining the source of the terrorist activity.

TRIA gives the Secretary of the Treasury the responsibility for determining whether an event falls within the TRIA definition of terrorism, which avoids some of the transaction costs associated with the determination. TRIA, however, does not impose a deadline or otherwise place parameters on the certification decision. Because of the significant risk of terrorism from within the United States and the difficulty of determining whether an event was by an international terrorist organization, the Task Force recommends that any future government-industry partnership for terrorism insurance not be limited to acts of terrorism that were committed by those “acting on behalf any foreign person or foreign interest.”<sup>81</sup>

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<sup>76</sup> See RAND, *supra* note 8, at 52-53 (summarizing the domestic threat and noting that “the public policy justification is unclear for creating a distinction between the treatment of threats emanating from neo-Nazis in New Jersey and from the transnational jihadists based in the Pakhtun tribal belt along the Pakistani-Afghan border”).

<sup>77</sup> Whether it is second or third most damaging depends on what is considered. The World Trade Center garage bombing in 1993 caused more losses in terms of costs (\$725 million compared to \$145 million), but the Oklahoma City bombing killed many more people (166 compared to 6). See Auriela Zanetti et al., *Swiss Re*, sigma No. 1/2002, *Natural Catastrophes and Man-Made Disasters in 2001: Man-Made Losses Take on a New Dimension* 17 (Thomas Hess ed., 2002). Moreover, even when one considers terrorism events around the world, the Oklahoma bombing was the eighth most costly and the sixth most deadly in history. *Id.*

<sup>78</sup> RAND report pp. 39-52

<sup>79</sup> See RAND at 53-54.

<sup>80</sup> See RAND at 54.

<sup>81</sup> Terrorism Risk Insurance Act of 2002 § 102(1)(A)(iv), Public Law No. 107-297, 116 Stat. 2322.

### **E. Retentions Should Be Set in Light of Financial and Market Circumstances**

The Task Force recommends that further consideration be given to the way that industry and company retentions are set in any government-industry partnership providing a terrorism backstop. Industry and company retentions should not be set arbitrarily; instead, the retention levels should be established in light of financial and market circumstances. One purpose of TRIA is to reduce the risk borne directly by insurers so that the market can function for a portion of terrorism risk. The retentions represent that portion of terrorism risk borne directly by insurers. The retentions should be set at a level that is neither too high nor too low. If retentions are set too high, they may create a risk of undesired insurer insolvency in the event of another major terrorist attack. If retentions are set too low, the government bears more risk than is necessary and insurers may not have a sufficient incentive to develop the reinsurance market for terrorism insurance.

The Task Force suggests that the retentions should take into account financial condition of insurers, or in other words, the insurers' general ability to pay claims up to the amount of the retention.<sup>82</sup> Factors that affect the financial condition of the insurers include: the price they can charge for terrorism and other insurance, the level of surplus capital, capital reserves required for other kinds of risks, and the returns on insurers' investments. At the same time, the Task Force also recommends that retentions should take into account the market circumstances for terrorism reinsurance. Availability of reinsurance strengthens the ability of primary insurers to pay claims up to the retention levels. But if the retentions are too low, insurers will not have an incentive to buy reinsurance, which will inhibit the development of the reinsurance market. Thus, the correct level of retention requires a balance between reducing the retained risk to an acceptable financial level, on the one hand, while leaving enough risk to maintain an incentive to develop the reinsurance market on the other.

TRIA includes both industry and per-company retentions, and both of those should be set in light of the considerations discussed. Although the Task Force does not have any specific recommendations for the appropriate risk retentions, it recommends that the following factors should be considered in setting the retention amount:

- Scope of coverage for lines of insurance. If the scope of coverage is changed, then it should affect the level of industry risk retention. Reducing the lines of insurance covered reduces the capital available to pay claims, and therefore would justify a lower industry retention.
- Surplus capital. Surplus capital is a reflection of the ability of an insurer to pay claims without becoming insolvent. Certain lines of insurance and some companies may have

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<sup>82</sup> Ability to pay (*i.e.*, surplus) should not be used as a measure for determining retentions to be imposed on individual companies because doing so may impose a penalty for good underwriting and/or management. Instead, the ability to pay is one gauge of whether the retentions are too high or too low. If the retention could be easily paid by most insurers, then the retention may be too low because it doesn't create an incentive for reinsurance. On the other hand, if the retention would threaten to put a significant portion of the insurers in financial distress or insolvency, then the retention is probably too high.

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more capital available than others, and surplus may be affected by the payment of, or reserves for, non-terrorist claims, such as those from hurricane losses.<sup>83</sup> To account for the multiplicity of possible risks, rating agencies generally require that no single risk account for more than 10% of an insurer's surplus. Because TRIA uses direct earned premiums to calculate retentions and does not consider surplus, it may not sufficiently protect against insolvency. The Wharton study analyzed the impact of TRIA retention levels on company surplus and found that the 2005 retention levels (15% of direct earned premiums), would be less than 10% of surplus for only 139 (or about 30%) of the top 451 insurers.<sup>84</sup> Retentions represented 15% or more of surplus for 172 of the 451 insurers (or about 38%).<sup>85</sup> The Wharton study also made projections of the impact of retention levels on surplus for 2006 and 2007 for the 30 largest insurers. It found that a 15% retention of direct earned premiums would likely exceed 10% of surplus for 14 out of 30 insurers,<sup>86</sup> and when the retention is moved up to 17.5% and 20% of direct earned premium, 8 insurers out of the top 10 and 18 out of the top 30 would exceed 10% of surplus.<sup>87</sup> These figures suggest that the retention levels may be too high, or perhaps that retentions should be based on surplus rather than direct earned premiums.

- Price for terrorism coverage. The price that insurers can charge for terrorism insurance affects their ability to accumulate the capital necessary to pay terrorism claims. In addition, it affects the ability of insurers to purchase reinsurance. If state price regulation artificially limits prices, it is harder for insurers to accumulate capital to pay the claims up to the retained amount, and to buy reinsurance.<sup>88</sup> On the other hand, a market price is more likely to represent an insurer's evaluation of the cost of bearing the terrorism risk up to the retention level considering available capital, reinsurance, and competition. If the market price were too high, one possible way to reduce that price would be by lowering the amount of risk retained by insurers. Assuming a rational market, the market price for terrorism insurance should be lower if insurers have to bear less of the risk in the first instance.

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<sup>83</sup> Insured losses resulting from 2004 hurricanes Charley, Frances, Ivan and Jeanne totaled approximately \$23 billion. See TRIA by the Numbers, July 2005.

<sup>84</sup> See WHARTON, *supra* note 10, at 96, Figure 6.2. Three insurers would be insolvent if they had to pay their maximum retention, and for 65 insurers the retention amounts to 30% or more of their surplus. *Id.*

<sup>85</sup> See *id.* For 80 insurers the 2005 retention represents between 10-15% of surplus. *Id.*

<sup>86</sup> See *id.* at 126, Table 6B.2. The retention would exceed 20% of surplus for 5 of the 30 insurers, and is projected as high as 75% of surplus for Arch Capital Group US and 43% of surplus for California State Compensation Insurance Fund. *Id.*

<sup>87</sup> See *id.* at 127, Table 6B.3. The retention would exceed 20% of surplus for 5 out of the top 10 and 17 out of the top 30. The higher retentions amount to more than 20% of the average surplus for the top 10. The most adversely affected insurer were Arch Capital Group US, for which 20% of direct earned premiums in 2007 would amount to 100% of surplus; HDI Group, for which 20% of direct earned premiums would amount to 70% of surplus; and the California State Compensation Insurance Fund (the fifth largest insurer considered), for which 20% of direct earned premiums would amount to 57% of surplus in 2007. *Id.*

<sup>88</sup> It should be noted that reinsurance is not subject to the kind of price regulation as is primary insurance. As a result, the gap between market-priced reinsurance and regulatory-priced primary insurance could be substantial, and could be a significant barrier to the development of the reinsurance market for terrorism coverage.

- Availability of reinsurance. The availability of reinsurance affects the ability of insurers to manage the retained risk. When reinsurance is available, insurers can share the risk with reinsurers, which further spreads the risk. If reinsurance is not available, insurers have to bear the risk themselves, which would require them to maintain greater capital on hand (both practically and because of capital requirements under state law). The analysis of reinsurance should also take into account projections for the development of the reinsurance market. One of the goals of TRIA is to encourage that market to grow. Consequently, the level of the retention should be set high enough that there is still room for that market to develop. Present information suggests that approximately \$5-6 billion of reinsurance capital is available for terrorism coverage at this time.<sup>89</sup> It is unclear how quickly that market will grow, but even if it grows at the pace of 60% by 2007, only about \$10 billion in capital would be available at that time.<sup>90</sup> This suggests industry retention should be set somewhat above \$6 billion. Although the amount of retention above the available reinsurance capital will help to promote market demand for reinsurance, at some level, depending on some of the other factors discussed above, the retentions may create a risk of insolvency for insurers.

#### **F. Nuclear, Biological, Chemical and Radiological Attacks**

A final issue that the Task Force suggests be studied in connection with any future government-industry partnership is insurance for nuclear, biological, radiological, and radiological (sometimes referred to as “NBCR”) attacks. At the present, there is little insurance coverage available for such attacks. Although TRIA requires that insurers offer terrorism insurance to their policyholders, they are only required to offer terrorism insurance on the same terms and conditions as property and casualty coverage for non-terrorism losses.<sup>91</sup> Because most property insurance policies have long excluded losses from nuclear and some chemical events, TRIA does not require terrorism insurance to cover such events.<sup>92</sup>

The absence of coverage for NBCR attacks represents a significant gap in insurance coverage for terrorism. The use of NBCR materials for a terrorist attack is a serious risk. According to RAND, “al Qaeda has long expressed an interest in the offensive employment of NBCR materials.”<sup>93</sup> Although al Qaeda has yet to demonstrate any such capability in an actual attack,<sup>94</sup> there is evidence of plans and efforts to develop it.<sup>95</sup> Models have shown that a large-

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<sup>89</sup> See *supra* note 12.

<sup>90</sup> See AIA, *Revamping TRIA: The Interplay Between Capital Constraints and Retentions* (2005).

<sup>91</sup> See Terrorism Risk Insurance Act § 103(C)(1), Public Law No. 107-297, 116 Stat. 2322.

<sup>92</sup> See RAND, *supra* note 8, at 6-7 (citing Marsh, Inc., *Marketwatch: Property Terrorism Insurance Update—3rd Quarter 2004*). See also WHARTON, *supra* note 10, at 86. It should be noted that workers compensation insurance is a notable exception to this because of the mandatory scope of coverage of workers compensation insurance. See *id.* at 81.

<sup>93</sup> See RAND, *supra* note 8, at 30. The RAND study cites a news interview of bin Laden in which he “specifically asserted that acquiring weapons of mass destruction (WMD) was a religious duty for all Muslims.” *Id.* See also WHARTON, *supra* note 10, at 50 n. 68.

<sup>94</sup> See RAND, *supra* note 8, at 31.

<sup>95</sup> See *id.* at 31-32.

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scale biological attack, such as with anthrax, could generate as much as \$90 billion in losses.<sup>96</sup> Nuclear or radiological attacks could have an even more severe impact.<sup>97</sup> The RAND study concluded that the “most profound risk” of uninsured losses is in the area of a NBCR attack.<sup>98</sup> The Task Force therefore recommends that the President’s Working Group on Financial Markets, the National Association of Insurance Commissioners, and others study ways to include NBCR coverage within the scope of the government-industry partnership providing a terrorism backstop.

### III. Conclusions

The Task Force believes that TRIA provided support that helped the insurance market to make terrorism insurance more available and that it was appropriate to extend TRIA. The backstop provided by the government-industry partnership reduces the front-end risk and provides an industry-wide pooling mechanism for potentially catastrophic losses. However, it seems unlikely that the risk of terrorism, or what we know about that risk, will so change in the next two years that the market will be willing and able to provide terrorism insurance without the backstop. The Task Force therefore recommends that a permanent government-industry solution be developed and adopted that will to continue to provide the framework necessary for market forces to develop capacity for highly unpredictable terrorism risk. The Task Force recognizes that there are several models for such a partnership. The Task Force also recommends that the following limitations of TRIA be addressed as part of any permanent solution:

- Preemption of state pricing and state “ensuring fire” requirements. If these state requirements are preempted by federal law, it will allow market forces to operate to set the price for terrorism insurance, which will allow development of capital and resources for purchasing reinsurance.
- Expanding coverage beyond acts of terrorism by those “acting on behalf of any foreign person or foreign interest” that occur in the United States. This would fill a coverage gap that currently exists for acts of terrorism by domestic groups, perhaps acting in sympathy with, but not on behalf of, foreign persons or foreign interests.
- Use financial and market circumstances to set retentions. This will allow retentions to be set at a level that is high enough to generate demand for reinsurance, but low enough to avoid significant risks of insolvency. Current retentions may be too high and may result in insurer insolvency in the event of another terrorist attack with losses similar or greater than those caused by the September 11 attack.

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<sup>96</sup> See WHARTON, *supra* note 10, at 50.

<sup>97</sup> See *id.* The RAND study suggests that a “dirty bomb” could contaminate an area as large as ten square miles, and that demolition of contaminated buildings may be the only practical solution, resulting in huge losses. See RAND, *supra* note 8, at 33.

<sup>98</sup> See *id.* at xii.

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- Expanding coverage to nuclear, biological, chemical, and radiological losses. This is another significant coverage gap that could undermine the protections of a government-industry partnership if a terrorist attack uses such means; expanding coverage to fill that gap would provide the benefits of insurance, such as incentives for mitigation and a claims-handling apparatus, which would be superior to reliance on after-the-fact governmental relief to address the economic impact of such an event.

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