

## Marketwatch: Terrorism Insurance 2006 President's Working Group Report to Congress

### Marsh's Property Practice



The President's Working Group on Financial Markets (PWG) publicly issued its report on terrorism risk insurance on October 2, 2006. The 2005 extension of the Terrorism Risk Insurance Act (TRIA) through December 31, 2007, required the PWG to conduct a study on the long-term availability and affordability of terrorism insurance, including group life coverage and coverage for chemical, nuclear, biological, and radiological (CNBR) events.

The analysis was assisted by staff members, who reviewed academic and industry reports, including Marsh's *Marketwatch: Terrorism Insurance 2006*. The group sought additional information through requests for comments and meetings with industry representatives. Marsh was a major contributor to the report, and we are grateful to the group for including us in its research. Among Marsh's contributions are the following:

- We responded to the PWG's request for comments on April 20, 2006.
- We provided copies of our 2004, 2005, and 2006 *Marketwatch* reports on terrorism insurance, which include much of the data used on pricing and take-up rates and which are referenced several times in the PWG's report.
- Jill Dalton of Marsh's Property Practice met with the members of the PWG on July 13, 2006, and provided comments on Marsh's experience in the terrorism

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insurance marketplace.

Generally, the report found a number of positive developments in the terrorism insurance market since September 11, 2001, including better risk measurement and management, improved modeling, increased reinsurance capacity, and a seeming willingness on the part of insurers to underwrite this risk. Perhaps most importantly, however, the report found that the “presence of subsidized Federal reinsurance through TRIA appears to negatively affect the emergence of private reinsurance capacity because it dilutes demand for private sector reinsurance.” The PWG’s report also concludes there is little potential for insurance-market development related to CNBR coverage.

Despite its findings, the report does not provide any recommendations, nor does it provide any direction with respect to the future of the federal government’s involvement in a terrorism insurance backstop. Several points imply that continued governmental involvement may not be necessary, while others point to a need for the backstop to continue in some fashion. The findings are neutral and are likely to be used by both sides in the upcoming debate as to whether TRIA should be extended, it should be allowed to expire without further action, or an alternative long-term solution should be sought.

The following are some of the report’s key findings and Marsh’s comments.

### **Long-Term Availability and Affordability of Terrorism Risk Insurance**

The availability and affordability of terrorism risk insurance has improved since September 11, 2001. The analysis points to an increase in take-up rates (the percentage of companies purchasing the insurance), a decrease in prices, and the allocation of additional capacity to terrorism risks as evidence. Based on Marsh’s data referenced in the report, take-up rates

more than doubled in a three-year period, increasing from 23 percent in 2003 to 58 percent in 2005. Better risk management and measurement, improved modeling capabilities, greater reinsurance capacity, and recovery in the financial health of property/casualty insurers are factors the report cites as contributing to the improvement in the terrorism insurance market.

We agree that improved modeling and risk management have allowed insurers to better identify their exposures and accumulations; however, we feel that these tools have actually resulted in a reduction in capacity, not an increase as the report suggests. This is especially true for risks in urban areas, for perceived target risks such as utilities, and for locations where there are large concentrations of employees.

The report points to increased availability of reinsurance capacity as a driver in the reemergence of the insurance industry. Although this has occurred to some degree, there is not nearly enough capacity to meet the demands of the members of the business community that currently purchase terrorism coverage. Colleagues at Marsh's sister company, Guy Carpenter, indicate that there is approximately \$6 billion to \$8 billion of available capacity in the reinsurance market for terrorism property risks. This would be inadequate to fill the gap that would be created should TRIA be allowed to expire.

Unfortunately, the report does not discuss this process of reinsurance-market adjustment in greater detail and, more specifically, the time this adjustment would take. The report recognizes that the reinsurance market for terrorism coverage has grown from virtually nothing to nearly \$8 billion since September 11, 2001. However, it would be prudent to consider a period of at least 10 more years until the reinsurance market has sufficient capacity to respond to a catastrophic terrorism loss. During this period, some form of federal support could continue to exist, with some increases in

retentions by the insurance industry, leading to incremental increase in demand for terrorism insurance and, therefore, motivation for the supply of terrorism reinsurance by the private insurance market.

The PWG's report states that the financial health and capacity of the insurance industry has improved; therefore, insurers have more available capital to allocate to writing terrorism risk. While this may be true, it fails to address TRIA's mandatory make-available provision. Without this requirement, insurers would be able to choose how to allocate their additional capital and whether to offer terrorism coverage at all. We believe they are likely to choose more predictable areas of risk where there is a proven history of positive financial results. Insurers are likely to cease offering terrorism insurance where they can—in areas like property and general liability—and redirect their capital only where they would still be required by law to offer terrorism risk insurance, such as workers compensation.

More critically, there is also a need to examine anticipated insurer behavior in the absence of TRIA or substantial private-market reinsurance. The report states that based upon the results of an A.M. Best survey, many insurers will continue to offer their current terrorism capacity. We believe the report is referring to the insurers' net capacity and not the gross capacity that they now offer, which is backed by TRIA. Without a federal backstop, insurers will supply their net terrorism capacity, which would result in reduced availability of terrorism insurance.

Anecdotally, in the period of uncertainty leading up to the extension of TRIA on December 22, 2005, commercial buyers of terrorism insurance witnessed—with some regularity—decreases in available terrorism capacity, from \$1 billion to between \$250 million and \$300 million. This was the result of smaller insurers' excluding terrorism coverage in the event of TRIA's expiration. A catastrophic terrorism loss to any of

Although strides have been made, Marsh does not believe reinsurance capacity will grow to sufficient levels to meet demand without a federal backstop of some kind.

these commercial buyers would have resulted in severe under-insurance for terrorism and, therefore, increased likelihood of business failure.

One point not addressed in the report is how, without the backstop of TRIA in the future, taking on this catastrophic risk would affect insurers' ratings by the rating agencies such as Standard & Poor's, A.M. Best, Fitch, and Moody's. After the 2005 hurricane season, changes in the methodology used by rating agencies—combined with upgrades in modeling software—had a significant impact on the amount of capital and/or reinsurance protection needed to achieve an acceptable rating. As a result of this pressure on capital, many insurers have reduced their exposures, bought additional reinsurance, and/or raised their prices for insuring such catastrophe risks as windstorm and earthquake. If insurers choose to write terrorism risk, they will simultaneously have to set aside additional capital, buy additional reinsurance, and/or charge higher prices to meet the demands of the rating agencies. The alternative is to suffer a downgrade in their ratings. Our experience with the insurance market for earthquake and windstorm capacity over the last year—which has been reduced dramatically—indicates that a severe restriction in available capacity for terrorism insurance will be the result.

The study concluded that after September 11, 2001, many lenders and investors began to put requirements into lending agreements and contracts requiring that owners and contractors purchase terrorism insurance—which is likely to have had an influence in purchasing decisions and take-up rates. It also states that financial institutions can force-place coverage if it is not available at commercially viable rates. If terrorism insurance is not available or affordable for building owners and developers, it is not likely to be offered by those insurance markets that provide force-placed policies for other perils, leaving this exposure uninsured. Many of these loans fuel the multibillion dollar mortgage-backed security industry. Many of the arguments made

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when TRIA was enacted were built on the potential loss of jobs and transactions if borrowers were unable to obtain insurance. We feel that those arguments are still valid today and that the impact on these important sectors of the economy will be very serious if terrorism insurance is not available or affordable.

Although the PWG's report quotes Marsh's data on take-up rates correctly, we do not feel it highlights what we view as very important indicators of demand.

- The industries perceived to be the most likely targets have the highest take-up rates—79 percent for real estate and financial institutions, 76 percent for health care, 74 percent for media, and 69 percent for hospitality.
- The Northeast, the geography perceived to be the most likely area of loss, has a take-up rate of 67 percent. What is more revealing is that the take-up rates in the other areas of the country, while not as high, have increased considerably since 2003.

These trends demonstrate an increase in the demand for the coverage. We do not agree with the PWG's conclusion that capacity would rise to meet this demand. As noted earlier, we believe insurers will focus their capital on more predictable lines of business and/or terrorism coverages mandated by law.

According to the report, one reason that 40 percent of all policyholders do not purchase coverage is an expectation that federal aid might be available if a significant attack were to occur. We agree with this statement and feel that TRIA is an excellent vehicle for distribution of those potential funds. Use of the commercial insurance marketplace to adjust losses, distribute funds, and collect a recoupment is one of the most efficient ways for the federal government and business to work together. It should be an important consideration in the development of a future plan.

## **Group Life Insurance**

Although group life insurance is not part of TRIA, coverage for terrorism insurance in group life policies has remained available, and prices have generally declined. The group life insurance market is quite competitive, resulting in an unwillingness on the part of insurers to raise prices or decline terrorism risk coverage. According to the PWG, there is no reason to expect negative developments in this insurance-market sector.

## **Chemical, Nuclear, Biological, and Radiological Coverage**

Insurance coverage for CNBR risk is not widely available. Insurers are not required to provide this coverage under TRIA (except for workers compensation), and many are reluctant to do so. Therefore, the report concludes there is little to no potential for future insurance-market development. Modeling issues concerning aggregation exposures and the probability of attacks, as well as a virtually nonexistent reinsurance market, are reasons for the negative outlook.

It is noteworthy that the potentially highest risk, a CNBR attack, seems to have no solution, and the report does not offer any suggestions.

## **Conclusion**

In the absence of a long-term solution, the report recognizes that all other risk-transfer mechanisms appear to be capable of underwriting U.S. terrorism risk—as has been the case for “noncertified” terrorism risk. However, the report does not acknowledge that the insurance market and the capital markets remain unwilling to be partners in the insurance for U.S.-certified terrorism risk—in the absence of a federal back-stop—because there is a higher certainty of returns elsewhere.

Marsh is grateful for the work undertaken by the PWG. We hope that this report will foster intense and positive discussions toward the creation of a long-term

solution for policyholders that need and demand coverage for terrorism risks and for insurers that are reluctant to provide that coverage in the absence of federal support. Several groups have proposed solutions. Time is of the essence to build a solution, as the Act's expiration on December 31, 2007, will start to affect renewals as early as January 1, 2007.

Creating and implementing an acceptable solution requires the active involvement of all policyholders and constituents. This can be achieved through companies' own government affairs staffs, trade associations, the Risk and Insurance Management Society (RIMS), the U.S. Chamber of Commerce, the Coalition to Insure Against Terrorism (CIAT), and/or direct communication with members of Congress.

To learn more about the PWG's Congressional report, terrorism risk insurance, and/or how Marsh's Terrorism Risk Specialty can help your organization, please contact your Marsh representative or:

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