Insuring Global Terrorism Risks

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President Bush signed the Terrorism Risk Insurance Act of 2002 ("TRIA"), into law on November 26, 2002. TRIA was initially met with enthusiasm as the U.S. was still grappling with the economic and personal losses from the attacks on September 11, 2001. However, as time has passed, much of the enthusiasm for the substantial government backstop provided by TRIA has begun to wear off.

This article will endeavor to accomplish three things: first, to give you an overview of TRIA and its provisions; secondly, to place TRIA into context with some similar government reinsurance pools of other countries; and, finally, to analyze how TRIA should be extended, if at all.

I. Overview and Beneficiaries of TRIA

First, what does TRIA provide? TRIA establishes the Terrorism Insurance Program (the "Program") administered by the Department of the Treasury, through which the United States federal government shares the risk of loss from foreign terrorist attacks with the insurance industry. Insurers are required to offer mandatory terrorism coverage, with the Program acting as reinsurer for much of the resulting losses. Insureds are also free to reject the offer of TRIA terrorism coverage and negotiate different terrorism coverage, or simply become uninsured as to the risk from a certified act of terrorism. Any terrorism exclusions in existing insurance policies that conflicted with TRIA were immediately nullified.

Federal reinsurance is triggered following an "Act of Terrorism" An "Act of Terrorism" is defined as: (i) a violent act that is dangerous to human life, property, or infrastructure; (ii) to have resulted in damage within the United States, or damage to a U.S. air carrier, a U.S. flagged vessel, certain U.S. based vessels or a United States mission; and (iii) to have been committed by an individual or individuals acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States government through coercion. It is noteworthy that TRIA does not cover purely "domestic" acts of terrorism.

Each participating insurer is required to pay losses up to a retention amount based on the insurer's direct earned premium written the previous year.[1] The federal government then covers 90% of the losses for the insurer above the insurer's retention amount, while the insurer would pay the remaining 10% of the losses.

II. International State Reinsurance Pools

Many countries have long-standing state-sponsored terrorism pools. Since September 11, 2001, additional countries have established pools and others are in the process of creating them. While many developed countries have some sort of state-sponsored terrorism pool, the coverage and mechanics of the pools differ considerably from one country to another.

Some countries (like the U.K.) provide reinsurance to insurers that voluntarily offer terrorism coverage, while other countries (like France and the U.S.) require insurers to offer terrorism coverage and then provide a reinsurance mechanism to limit the insurers' overall exposure. The type of state-sponsored coverage often relates to that country's experience with terrorism.

For example, the international reinsurance market withdrew capacity from the U.K. as a consequence of IRA terrorism in the 1990s. This led to a state-sponsored solution: limited private cover with additional excess cover for both property damage and business interruption made available for insurance companies to cede to Pool Re (which sets rates and terms). In 2002, coverage was extended to an all risk property basis (including nuclear, biological and chemical, "NBC"), except for war and hacking and virus damage. Effective 2003, maximum industry retention is increased to £30 million per event and £60 million per year, with individual insurer retention based on market share. Pool Re does not require that direct insurers offer terrorism coverage; but, if they do so, Pool Re provides reinsurance for acts of terrorism. The U.K. government acts as Pool Re's "reinsurer of last resort," in case of insolvency.

The German Insurance Association, GDV, formed a pooling arrangement named Extremus AG, with government assistance. Composed of three layers, the first layer of €1.5 billion is provided by the private market. International insurers and reinsurers provide the second layer of €1.0 billion. The German government backs the third layer of €10.0 billion. Cover applies to commercial risks of more than €25.0 million. Insureds are not required to purchase terrorism insurance.

France, like the U.S., has taken the position that insurers are required to offer terrorism insurance. France's co-reinsurance pool, Gestion de l'Assurance et de la Réassurance des Risques Attentats et Actes de Terrorisme (GAREAT), was established to cover the terrorism exposure of all eligible risks. Membership in the pool is obligatory for all members of the FFSA, the French Insurance Association. The scheme operates progressively through four layers: (1) direct insurers up to €250 million, (2) reinsurers up to €1.0 billion, (3) Caisse Centrale de Reassurance (state reinsurer) up to €1.5 billion, and (4) state unlimited thereafter.

Congress passed TRIA in response to what it perceived as a financial marketplace need because borrowers could not get affordable terrorism cover, leaving lenders exposed to what was considered a pervasive and catastrophic risk. As a result, TRIA requires insurers to offer terrorism coverage but does not require insureds to accept the coverage. This hybrid approach combines the reinsurance feature from the U.K. pool with France's mandatory availability. The result is available state-sponsored reinsurance without an insured obligation to purchase coverage.

Unlike the broader reinsurance coverage afforded by Pool Re, TRIA's mandated coverage is generally limited to non-NBC acts of terrorism. This limited required offer of coverage is TRIA's main criticism because it does not appear to provide coverage for the most prevalent future risks of catastrophic terrorist attack. As a result, there is an ongoing debate whether TRIA is an effective response to the economic and social risk currently faced by terrorism.

III. Should TRIA Sunset or be Renewed in Some Form?

Most commentators now think that TRIA will be allowed to sunset, or expire by its terms, on December 31, 2005. Without a major act of terrorism within the U.S., we think that they are probably correct. However, if there is a major terrorism event, we believe two things will happen. First, the business community (primarily lenders) will be surprised by the lack of effective coverage because of the exclusions mentioned above and the fact that many businesses did not elect to purchase TRIA coverage. Secondly, we believe there will be political pressure to extend TRIA, but perhaps in a different form. .

Our recommendation of that form would track the French model. That model would require insurer participation (perhaps allowing for a sizable deductible or self-insured retention), followed by a mandatory industry reinsurance pool, and a government backstop above the pool limits. This method would provide coverage for U.S. business interests, mandate reinsurance participation and provide – at some level – government support.

(Endnotes)

[1] The insurer retention amount is 7% for 2003, 10% for 2004, and 15% for 2005.