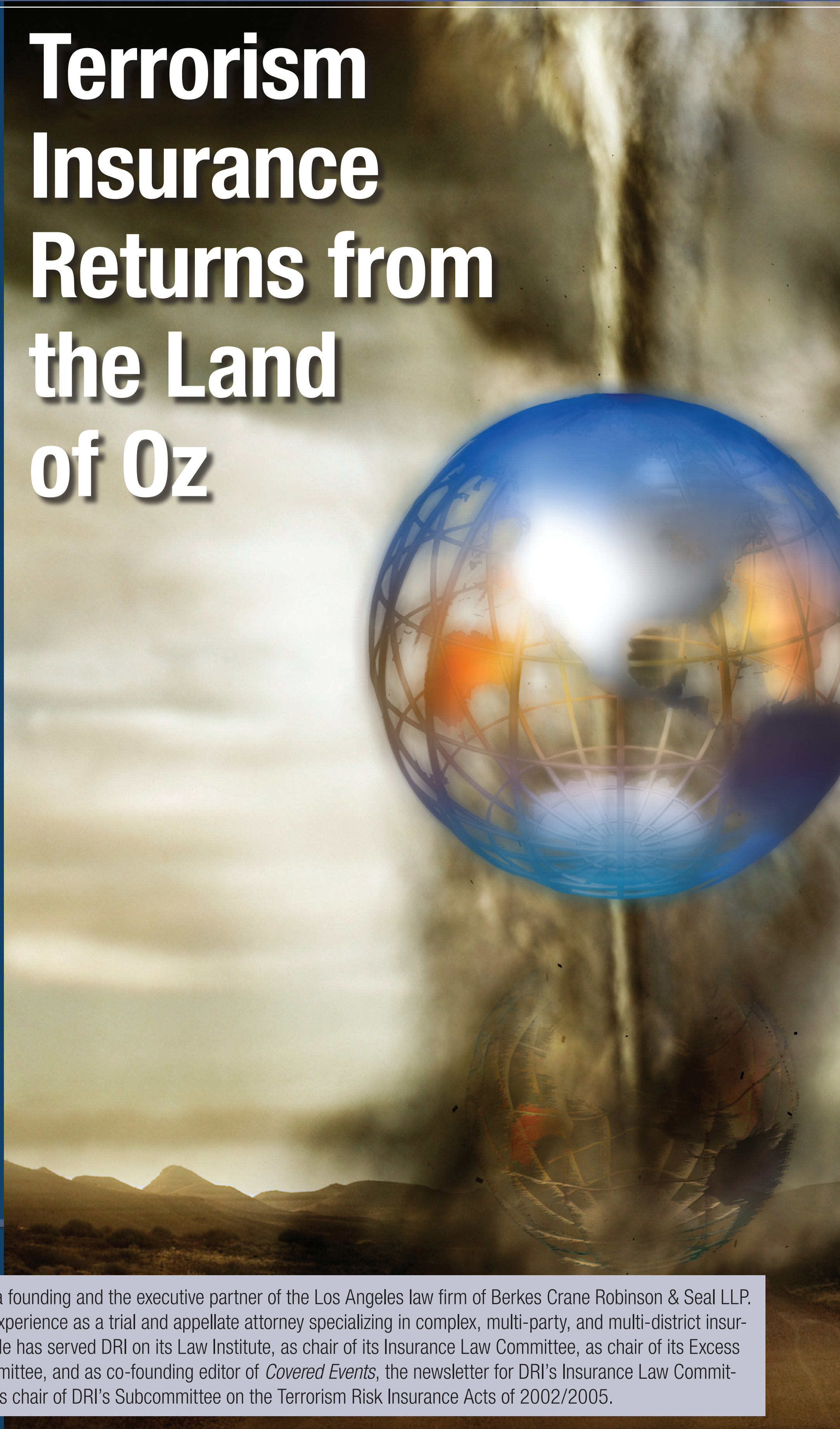
"TRIA, TRIEA and TRIREA—Oh My!"

# Terrorism Insurance Returns from the Land of Oz



By Ronald R. Robinson

**TRIREA will provide stability to the marketplace and create a solvent and viable long-term insurer/governmental insurance program that appropriately shares terrorism risk.**

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After being catapulted by a tornado into the Land of Oz in one terrifying moment, Dorothy was forever changed by her journey to find a way back home. After being uprooted by the social, economic, political and civil justice tornado that was unleashed by the terrorist attack of September 11, 2001, America, too, has been forever changed by its journey to find a way back home. Among its many catastrophic alterations to the fabric of our society, that devastating event catapulted insurers into their own nightmarish Oz, a land where 400 years of risk transfer underwriting, risk modeling and loss rating principles were uprooted in one terrifying moment. The greater insurance community has been forever changed by its journey, over the past six years, to create a solvent and viable terrorism insurance program, but it is not yet all the way back home. A principled debate still rages on the question of how best to transfer this risk in a private market driven economy.

That journey has, thus far, led policyholders, insurers and Congress to create an unprecedented partnership of private financial markets and governmental funds to provide coverage for this largely unknown, unknowable and un-ratable risk of loss. First came the Terrorism Risk Insurance Act of 2002 ("TRIA"). Next came the Terrorism Risk Insurance Extension Act of 2005 ("TRIEA") that will expire on December 31, 2007. TRIA and TRIEA are federal statutory programs that, together, have put in place a five-year terrorism insurance program that relies on the resources of the private financial markets and government funds to transfer this risk safely and without undue disruptions in the social, economic, political and civil justice principles that define our nation. TRIEA today provides a $100 billion terrorism risk insurance program for losses caused by foreign terrorists. Without a successor to this program that continues to partner private financial markets and governmental funds to provide terrorism insurance, there can be no long-term solution to the significant, unprecedented and all-encompassing societal challenges that attend the transfer of this risk. Today, we are about to take the next major step in this journey. Will it take us all the way back home?

Congress, the Treasury Department, insurers, policyholders and the extended technical and regulatory communities are the stakeholders in the continuing debate over what, if anything, is or ought to succeed TRIEA. The first tangible result of this debate is H. R. 2761, the Terrorism Risk Insurance Revision and Extension Act of 2007 ("TRIREA"), now in the hands of the U. S. Senate's Banking and Urban Affairs Committee. TRIREA is the House of Representatives' Financial Services Committee's proposal to extend, refine and expand TRIA and TRIEA, creating a terrorism risk insurance program that is well intended and that will serve for 15 more years, ending December 31, 2022.

DRI has played a significant part in this journey through its TRIA Subcommittee which has, since 2004: (1) led a non-partisan effort to extend, refine and broaden the terrorism risk insurance programs now in place; (2) written numerous white papers analyzing the questions that must be answered to create a viable, solvent and comprehensive program that provides a long term solution to the transfer of this risk; and (3) advocated a final approach to coverage that respects and strengthens the historic and separate roles of private financial entities, the federal government and the civil justice system in a free society. The TRIA Subcommittee's journey has led it to propose a long term solution that: (i) covers domestic as well as foreign terrorist attacks; (ii) includes all lines of insurance; (iii) provides for coverage based on a statutory or policy based definition of a terrorist loss, as opposed to a politically governed certification that such losses are covered; (iv) preserves recourse to the civil justice system for disputes that might arise over terrorism's losses; and (v) creates a Commission on Terrorism Risk Insurance to provide non-partisan oversight of and recommend changes in any long term solution throughout the life of such a program. With TRIREA—H.R. 2761—the TRIA Sub-

committee believes that we *are* almost home.

### H.R. 2761—TRIREA; a Responsible Start For a Solvent and Viable Long Term Terrorism Risk Insurance Solution

#### A Continuing Private/Public Coverage Partnership Is Necessary and Possible

Given the current $170 billion total policy surplus for all current TRIEA insurance lines combined, the private market alone cannot, without risking insolvency, cover its historical obligations and assume the additional risk of the $100 billion in terrorism losses that are to be protected under TRIREA. Insurers cannot responsibly undertake 100 percent of this or any other risk if they cannot employ historical loss control measures to protect their solvency. The federal government is the only entity that has the means and opportunity to perform "loss control" measures *vis-à-vis* terrorists and their attacks. It is Congress and the Executive Branch that controls the domestic and foreign policy agenda targeted by terrorists and that controls the intelligence gathering, law enforcement and military assets required to thwart their national and global based attacks. Private insurers can perform none of the classic loss control functions for terrorism risk. This fact mandates a lower and more appropriate share of this risk for insurers in any program. TRIREA continues the private/public partnership and justifiably returns the insurers share of this risk to the levels assumed by them in year three of TRIA.

Given the magnitude of terrorist attacks we now know is possible, insurers cannot accept the *entire catastrophic loss* that attends them and then get safely home simply by clicking a pair of ruby slippers. By capping potential losses and continuing to provide a rational federal backstop, TRIREA will provide stability to the marketplace and create a solvent and viable long-term insurer/governmental insurance program that appropriately shares terrorism risk. Without a government partner, the goals of any proposed long term solution will be not be achieved and another terrorist attack will have a significantly more devastating impact on our economy.

There is no empirical support in the Executive Branch's June 2005 Treasury Report on TRIA or its September 2006 Presidential Working Group ("PWG") Report on TRIEA, for the proposition both advance; *i.e.*, that the federal government can abandon its current share of this risk any time soon. What is debatable over the next decade is the share of risk each partner ought to bear. The insurers cannot absorb a $100 billion exposure alone because this risk is not easily modeled or reserved by any private entity. Likewise, there is no basis for the Executive Branch's proposition that the government role in TRIA or TRIEA has or will suppress market capacity. The original risk share allocation approach has been demonstrated to be viable and correct for the time being. TRIA and TRIEA have enabled the private direct and reinsurance markets to assume the limited risk those programs demand of them.

#### TRIREA'S Proposed 15 Year Term Is Warranted

TRIA and its successor, TRIEA, were enacted to support insurers and their reinsurers while they found ways to return to the marketplace with increased capacity to provide viable terrorism coverage without government help. That goal is not abandoned in TRIREA. This bill directly accepts the challenge to meet that goal and has several key provisions designed to address it and move responsibly toward it. The proposed 15 year term is a market based time frame that the real estate and lending communities have demonstrated to be the minimum period required to stabilize the market place long enough to work realistically toward that goal. Both of the Executive Branch reports candidly admit in their detailed discussion sections that, without TRIA and TRIEA, terrorism insurance would be scarce and very highly priced. Although the 2006 PWG Report provides a painstaking analysis of relevant facts, figures and projections, its pronouncements do not address the ultimate challenges facing the economy without a governmental terrorism insurance backstop. Moreover, the PWG's ultimate market conclusions are not supported by the report that underlies its policy recommendations.

#### Conventional Losses Are Now Better Protected

TRIREA maintains the current requirement that insurers "make available" coverage for so-called "conventional terrorism losses." The industry deductible remains at 20 percent with a "reset mechanism" for events over $1 billion. The current federal share of loss—85 percent—remains above the insurer deductible. However, the federal share itself can reach as high as $100 billion in a given year; this is an increase of $15 billion. TRIREA adds domestic terrorism as a covered loss. It also returns the current per event loss "trigger" of $100 million to the $50 million "trigger" that was required for coverage under TRIA. The proposal establishes exclusive Federal Court jurisdiction for disputes involving an insurer's responsibility for these losses. The government can, but need not, recoup up to $27.5 billion of federal payments for property/casualty insured certified terrorism losses (subject to three percent annual cap). The TRIA Subcommittee supported these concepts and wrote over 25 white papers on these and other proposals discussed below that are now present in TRIREA.

#### Non-Conventional NBCR Losses Are Added

The most dramatic step taken in TRIREA is the proposed coverage for "non-conventional losses;" i.e, an act of terrorism involving nuclear, biological, chemical, or radiological reactions, releases or contamination—"NBCR losses." Insures must "make available" coverage for NBCR losses to "any policyholder who elects conventional terrorism coverage." This coverage will not be "in place" until January 1, 2009, and there will be a two-year phase-in of NBCR forms regulations and a three-year phase-in of the relevant rate regulations. The deductible scheme in place for conventional losses is replaced by specified lower NBCR loss deductibles. TRIREA also authorizes Treasury to (i) exempt certain small insurers from the program and (ii) make provision for instances of NBCR loss related insurer insolvencies. Insurers with direct earned premiums of less than $50 million in a calendar year are exempt from NBCR coverage. The government's share of NBCR losses ranges from 85 percent to 95 percent, on a sliding scale of $10 billion to $60 billion. The TRIA Subcommittee advocated a separate NBCR program, outside of TRIREA, for this coverage utilizing similar principles.

### Political Certification Required for Coverage

The Secretary of the Treasury acts as the claims manager for TRIREA. The Secretary, in consultation with the Attorney General and the Secretary of State, determines whether a loss qualifies for protection under the Act. TRIREA adds a separate certification by Treasury for an act of NBCR terrorism. It also provides that the Secretary of Homeland Security will join the other officials consulted by Treasury in certifying acts of terrorism.

The TRIA Subcommittee has always questioned whether the certification process is adequately protected from the political agendas that might be brought to bear in certain attack scenarios. Difficult business and trade issues may well attend an allegation that certain foreign or domestic interests or states be certified as the source of an attack. This problem can be eliminated if an event qualifies for TRIREA protection based on a classic "grant of coverage"—be it in each policy or in statutory law. Federal courts, as required, can enforce coverage grants written in statutes or policy forms. Such "certification by law" is preferable to the current approach that mandates a politically based decision process through certification by Executive Branch officials. There is no appeal from a certification decision, no checks and balances to alter that decision and no recourse for redress except political pressure. This mechanism, which violates a core precept of our Bill of Rights and our Constitution, ought to be altered in the final bill.

### An Apolitical Loss Certification Statute or Policy Provision Is Constitutionally Required

TRIREA should cover all losses that result from a domestic or a foreign based "act of terrorism" without certification by the Executive Branch. DRI's TRIA Subcommittee proposes the following statutory or policy coverage definition:

> A Covered Terrorist Loss is the result of a violent act or an act that is dangerous to human life, property or infrastructure;
> — that occurs within the United States, or outside of the United States, but only if on a U.S. air carrier's property or vessel, as defined, or on the premises of a U.S. mission; where
> — the loss is caused by the act of an individual, or individuals, acting on behalf of any person or interest with the intent to interrupt, disable, or destroy social, economic, legal, or political operations, and/or infrastructures of another individual, a cognizable group of individuals or any city, county, state or federal governmental entity in the United States, in order to, or to attempt to, coerce or intimidate such individuals, groups, or governmental entities to change a social, economic, moral, religious, political, or ideological belief, doctrine, policy, position, or ideal or to alter or affect the private or public course or conduct of such individuals, groups or government entities in the exercise of their inalienable civil rights or powers, as part of an effort to coerce the civilian population of the United States or to influence the policies of its various governmental entities or to affect the conduct of its governmental entities, by means of intimidation, coercion or acts of violence.

The TRIA Subcommittee asks the Senate to add this concept to TRIREA and to remove the current politically based certification process.

### TRIREA Cover Should Be Available in All Lines of Insurance

If all policies were to be made available under TRIREA, there would be more "TRIREA premium" to support the industry's deductible and recoupment obligations. This expansion of coverage would also increase the industry's overall premium base and all private financial markets would be more stable. Moreover, there would be more insurance "capacity." More "capacity" means more direct insurer coverage can be made available to the market place. More direct coverage, in turn, means more premium can be paid to re-insurers. More re-insurance premium increases re-insurance "capacity."

To paraphrase Mark Twain, everyone talks about increased "capacity," but no one does anything about creating it. Including all lines of insurance in the "make available" framework that now exists for the currently designated lines *will do something* about "capacity." It will increase it in a manner that is wholly driven by the private sector. The Executive Branch has touted increased "capacity" as the Holy Grail of a stand-alone private sector terrorism insurance program. It should, therefore, support this concept and the 15-year program term that is needed to build sufficient "capacity" to reduce the federal government's share of TRIREA losses.

> **A principled debate** still rages on the question of how best to transfer this risk in a private market driven economy.

TRIREA adds farm owners' multiple-peril, group life, term life, group universal life, group variable universal life and accidental death insurance to the program. TRIREA has a separate \$5 billion recoupment option for life insurance via a post-event policyholder surcharge (subject to 0.0053 percent annual cap). However, DRI's TRIA Subcommittee calls upon the senate to add (i) crop insurance, (ii) private mortgage or title insurance, (iii) financial guarantee insurance, and (iv) all professional liability, health and auto covers. These now excluded covers *are on the risk* for terrorist caused loss scenarios. Terrorism seeks to destroy life and property, to erode one's sense of security, and to govern through fear, not free choice. These specific lines of insurance seek directly to protect life and property, preserve a sense of security, and provide choices, free from fear, to build anew for "main street Americans." As yet, they are not directly protected by TRIREA. These lines of insurance can play a singularly valuable role in the lives of ordinary citizens in the war against this old, but newly dangerous, enemy, simply by making these covers available for terrorism losses at a nominal premium. Why not add



these lines and, at the same time, broaden the premium base for this risk?

The PWG states that "Increased demand and increased prices… attract new capital and new market participants." "Make available" coverage in all lines will exponentially increase capital and "capacity" in direct and reinsurance markets. This expansion would likewise eliminate adverse cover selection by higher risk policyholders. Traditionally, business interruption covers also contain some esoteric extensions sometimes referred to as "Civil Authority Coverage" or "Ingress/Egress Coverage." These lines within business interruption insurance covers provide loss protection when access to the insured property is barred by order of Civil Authorities. Contingent Business Interruption Coverage or service interruption coverage protects the earnings of the insured following physical loss or damage to property of the insured's suppliers and/or customers. Service Interruption Coverage is similar. It provides coverage for an insured for disruptions caused by interruptions in the supply of water or power. Steps must be taken to ensure that these "extensions" are also specifically addressed in the new TRIREA program. So far, too many covers are not part of this program. The TRIA Subcommittee asks the Senate to add them to TRIREA.

### The Proposed Congressional/Executive Branch Oversight Commission

H. R. 2761 proposes a Commission on Terrorism Risk Insurance ("Commission") to identify and recommend possible actions or mechanisms (1) to encourage, facilitate and sustain private insurance for coverage for terrorism losses; (2) to sustain or supplement the ability of the insurance industry to participate appropriately in the program; and (3) to reduce the governmental role in the program. The Commission is also specifically tasked to evaluate the utility and viability of proposals aimed at improving the availability of private market terrorism insurance. The Commission will hold its first meeting in July of 2009. The first of two comprehensive reports will be issued by it in 2013 and the second will issue in 2016. These reports will: (1) evaluate and make recommendations regarding whether there is a need for federal terrorism insurance; (2) make detailed recommendations for the replacement of or reduction in the federal role; and (3) propose ways and means to accomplish the foregoing goals.

Why is a Commission needed? The stakeholders in the ongoing debate about all aspects of TRIREA that will evolve over the next 15 years are adversaries in the market place. These market place competitors, by definition, find it difficult to reach consensus in the absence of a neutral forum to debate solutions. Each has "turf" and prerogatives to protect. This is true as regards (i) insurer to insurer negotiations, (ii) insurer to re-insurer negotiations, and (iii) insurer to policyholder negotiations. The past five years demonstrates that direct negotiations among these competitive private market stakeholders and between them and Congress will not yield closure or consensus. H.R. 2761 proposes that future changes to TRIREA be recommended by this Commission. The TRIA Subcommittee asks the Senate to preserve this provision of TRIREA.

The Commission approach, by definition, builds common ground and consensus—the prerequisites of broad based support for any needed changes. It also has the ability and opportunity to propose responsible and non-partisan amendments to TRIREA over the next 15 years. The Executive Branch opposes a five-year, let alone a 15-year extension. The existence and mandate of the Commission ought to give comfort to the Executive Branch that the goal of a reduced or unnecessary federal risk share is part of TRIREA's agenda. The Commission's presence in the bill ought end the debate over the program's "term" because of the oversight work it will perform and the reports it will issue. If the Executive Branch is correct, the Commission will logically recommend altering the risk allocation of the program as the market place permits, over time. The economic stability a 15 year program will create is worth the "risk" of a process of considered modifications that are demonstrably warranted by facts developed and reported by the Private Markets/Congressional/Executive Branch balanced membership of the Commission.

The Commission is to include: The Treasury Secretary and a state insurance commissioner selected by the NAIC. The next President of the United States will appoint: a representative of group life insurers; a representative of property and casualty insurers with direct earned premium ("DEP") of $1 billion or less; a representative of property and casualty insurers with DEP over $1 billion; a representative of multi-line insurers; a representative of independent insurance agents; a representative of insurance brokers; a policyholder representative; a representative of the casualties of September 11; a representative of the reinsurance industry; a representative of workers' compensation insurers; a representative from the commercial mortgage-based securities industry; a representative from a nationally recognized rating agency; a real estate developer; a representative of state workers' compensation funds; a representative from the commercial real estate brokerage industry or the commercial property management industry. Congress will appoint four members; two to be selected jointly by House Financial Services chair and ranking member and two to be selected by the Senate Banking chair and ranking member. Treasury's TRIREA Program Director will act as Secretary of Commission. This make-up ensures that the on-going debate will be led by a non-partisan and balanced Private Markets/Congressional/Executive Branch Commission and that there will be reliable and persuasive reports to Congress and the American people in 2013 and 2016 on appropriate modifications to the program, as and if warranted.

The Executive Branch ought to support the Commission on its merits alone. However, the House Financial Services Committee has adroitly added a purely Executive Branch controlled study group to balance the Commission's influence. TRIREA mandates a "Treasury Study" every two years for the life of the program. The Treasury study group consists of the Secretary and a group of consultants chosen by him or her drawn from NAIC and the insurance, securities, and policyholder communities. Their mandated biannual reports to and testimony before the House Financial Services and Senate Banking Committees will address the long term availability and afford-

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ability of private insurance for terrorism risks. These reports will serve to balance the views of the Commission and provide timely analysis and a recommendation between its scheduled two formal reports. With this solely Executive Branch group in place, there is no valid reason why the Commission ought to be opposed by it.

The DRI TRIA Subcommittee initiated the debate for this Commission in 2004. The Subcommittee has been credited by Representative Barney Franks, Chair of the House Committee on Financial Services that promulgated H.R. 2761, with creating and successfully advocating the Commission initiative as first included in the House's proposed TRIEA Extension Bill in 2005. Sadly, the Commission provision in TRIEA was removed by the Senate in the final bill signed by the President that continued TRIA from 2005 to 2007. However, TRIREA's version of the Commission is even closer to the original one proposed by DRI three years ago. The Subcommittee calls upon Congress to preserve the Commission and the Treasury Study Group in the final bill to ensure a balanced ongoing debate on the need for and modifications to TRIREA.

### H. R. 2716 Update—Attend The Annual Meeting Panel Entitled: "Moving Insurance Legislation Through Congress—TRIA and Other Bills"

The TRIA Subcommittee will present the above noted panel discussion at DRI's Annual Meeting in Washington D.C. as the Insurance Law Committee's MCLE presentation at the latter's meeting at 4:30 pm on Thursday, October 11, 2007. Legislative affairs professionals from two prominent trade associations and, schedules permitting, senior Congressional staffers, will update you on the status of the TRIREA debate and explain how the legislative process works for insurance legislation.

If you want to learn more about TRIREA and its critical issues in order to follow or participate in the national debate on the proper long term solution to terrorism risk insurance that will culminate in the next five months, the members of the TRIA Subcommittee have written 16 white papers that are published in a DRI Compendium entitled "The Future of Terrorism Risk Insurance." The Compendium also includes an exhaustive research database for further study. This resource, given *pro bono* to all stakeholders in the debate over the last three years, has now been augmented by nine topical papers published by Subcommittee members in this year's editions of *For The Defense*. The TRIA Subcommittee hopes to finish its journey over the next few months, as the Senate enacts its bill and that proposal, along with H. R. 2761, is debated through the conference committee process. If our goals are achieved, we, like Dorothy, can truly say "There's no place like home."