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Statement No. 207

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Statement of the Shadow Financial Regulatory Committee

On

the Possible Extension of the Terrorism Risk Insurance Act

May 24, 2004

The Terrorism Risk Insurance Act (TRIA) of 2002 established a three-year program to provide a federal backstop for private sector insurance coverage of specified risks of loss from terrorist attacks. TRIA is scheduled to expire on December 31, 2005. The Treasury must determine by September 1, 2004 whether to extend the Act's "make available" provision, which requires property-casualty insurers to offer terrorism coverage under the same general coverage (as opposed to price) terms as other risks of loss.

While details are unlikely to be available prior to the conclusion of a Treasury study on the effects of the Act scheduled for release by June 2005, existing evidence indicates that a large majority of businesses have nonetheless declined to purchase terrorism coverage, apparently because they believed that premium rates were too high in relation to their risk. Not surprisingly, more businesses have purchased terrorism coverage in major cities with greater exposure to terrorist attacks. Reinsurance for insurers' share of any insured losses under the program appears generally to be available, although the demand for such reinsurance is soft. A number of major insurers are offering broader terrorism coverage than is backed by TRIA.

The Shadow Financial Regulatory Committee's September 23, 2002 statement (Statement No. 182) on a proposed federal backstop for terrorism insurance and reinsurance, written two months prior to TRIA's enactment, indicated that markets were already adjusting to the events of September 11. Insurers and reinsurers were raising significant amounts of capital, and insurance coverage for terrorism losses was becoming more available. Premium rates, while high, were declining. There was no evidence of any widespread reluctance of lenders to finance commercial property. The Committee recommended that any federal backstop for terrorism insurance should: (1) be temporary, e.g., lasting two or at most three years, with strong sunset provisions, (2) include substantial elements of private sector risk bearing, and (3) avoid any direct government charge for assistance, which could lead to a long-term program. TRIA is largely consistent with those principles.

Insurance regulators and representatives of insurers, insurance brokers, commercial real estate lenders and developers, and corporate risk managers are (1) pressing the Treasury to extend TRIA's "make available" provision through 2005, and (2) pressing the Congress to extend and possibly expand the federal backstop program beyond 2005. They stress that quick action is needed to facilitate negotiations of insurance contract renewals and avoid destabilizing insurance and real estate markets, with attendant adverse effects on economic activity, including commercial construction in New York, Washington, and a few other large cities.

The Committee believes that the arguments for extending the Act beyond 2005 are unpersuasive. Nor should the Treasury extend the Act's "make available" provision through 2005. The principal effect would only be to increase pressure for extending the entire program beyond 2005, in order to avoid practical problems for policies with renewal dates after the December 31, 2005 sunset date.

The property-casualty insurance industry is stronger financially than when TRIA was enacted. No convincing evidence indicates that extending the program is necessary to avoid serious disruptions in commercial real estate markets in major cities. The Committee also questions whether encouraging development of high-value properties in high-risk areas is appropriate policy.

Property-casualty insurer representatives stress that two problems would result from failure to extend TRIA. First, under state law, workers' compensation insurers would still be required to cover injuries caused by terrorism. Second, about half the states, including California, Illinois, and New York, prevent property insurance policies from excluding coverage for fire damage caused by terrorism. Thus, state law would require companies to provide terrorism coverage without a federal backstop. Any federal intervention into terrorism insurance markets after 2005 should be limited to workers' compensation insurance and possible preemption of state mandates that property insurance policies include coverage for fire losses caused by terrorist attacks.

If the Congress instead does decide to extend TRIA, the program's scope should not be expanded, and the amount of losses that the private sector must bear before federal assistance kicks in should increase annually over the duration of any extension. Regardless of whether TRIA is extended, the Congress should focus on reforming policies that inhibit private sector capacity to provide insurance and reinsurance for terrorism losses at premium rates that many businesses would find attractive. Serious consideration, for example, should be given to whether modifications in the corporate income tax code are desirable as a means of reducing insurers' and reinsurers' costs of holding the large amounts of capital required to provide coverage, thereby increasing supply, reducing premium rates, and reducing demands for any federal backstop program.