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can Enterprise Institute

endent committee
d by the
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w.aei.org

Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

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For Information contact:

Scott Harrington
803-777-4925
Peter Wallison
202-862-5864

Statement of the Shadow Financial Regulatory Committee

On

Terrorism Insurance

December 3, 2001

Estimates of insured property and business losses in excess of $50 billion from the destruction of the World Trade Center and uncertainty concerning the future course of terrorism have caused reinsurers around the world to threaten withdrawal of terrorism coverage. Primary property and casualty insurance companies have indicated that, unless the government steps in to provide last resort reinsurance coverage, they therefore will seek to exclude terrorism risk from new and renewal insurance contracts beginning in 2002. Banks that finance buildings and other facilities are less likely to lend when there is a risk that the collateral will be destroyed with no insurance behind it. Increases in loan rates, denials of financing for new construction, or the defaulting of loans to weak borrowers would involve significant, economy-wide costs.

Some evidence indicates that insurance markets are beginning to digest the September 11th attacks and subsequent events. Significant amounts of capital are being raised to support the sale of insurance and reinsurance. Although it is not clear how much new capital would be devoted to supplying terrorist coverage without government intervention, it is plausible that at least some reinsurers, who are in the business of taking and spreading risks in exchange for premiums, would be willing to take on the newly evident risks.

Nevertheless, the insurance industry consensus is that there will be relatively little terrorism coverage after January 2002, in large part because of the potential for enormous loss and the inability to price the risk of loss accurately. The

Administration, the insurance industry, and members of Congress have considered a number of plans for the federal government to assume substantial portions of terrorism insurance risk—and thus encourage the inclusion of terrorism coverage in insurance contracts coming into force in 2002 and future years. The House passed a terrorism insurance bill on November 29. Several bills have been introduced in the Senate, most notably a bill co-sponsored by Senator Gramm, which incorporates some features of an earlier Administration proposal.

Given the possibility of significant, short-term disruptions in insurance markets with material detrimental spillovers on economic activity, the enactment of some form of federal backstop for terrorist coverage is probably prudent. A key issue is whether the current problems in insuring against terror are long term or short term. Barring any large and unexpected increase in the threat of attacks, the Committee believes that over time – and a relatively short time – private insurance markets will be able to price and devote the resources necessary to provide terrorism coverage efficiently.

An appropriate federal backstop for terrorism insurance coverage should reflect the following principles:

1. Any program should be temporary, structured so that the insurance industry will take on full responsibility for terrorism losses relatively quickly, and include built-in phase-outs over two or at most three years with strong sunset provisions.

2. There should be a substantial layer of private risk-bearing before government assistance kicks in and risk-sharing by private insurers and reinsurers once any threshold for assistance is reached. That approach would mimic private insurance/reinsurance for catastrophes. Consistent with insurers' ability to adapt and the rapid phase-out of assistance, the threshold for government assistance should increase each year.

3. Intervention should avoid any direct government charge for assistance or government approval of premium rates. Efforts to set rates or impose rate regulation as a "price" for the government absorbing some terrorism risk should be firmly resisted. Although there is some public interest in holding down rate increases, that interest is best served by getting the private sector back in the business of insuring against terrorism risk as quickly as possible—a task that rate regulation can only delay.

4. A backstop program should avoid mandating that an insurer offer coverage to all policyholders as a condition for participating in the government program. Such mandates might lead to government intervention in pricing decisions.

A program that reflects these principles would target the short-run problems, encourage private sector risk spreading, and reduce the potentially adverse effects of federal subsidies on private sector risk assessment, risk management, and claims adjustment. On a longer-term basis, allowing insurers and reinsurers to accumulate some amount of capital (reserves) on a tax-deferred basis would make insuring potentially large losses from terrorism (or natural disasters) cheaper and more abundant. It would make future problems less likely.

The terrorism insurance bill approved by the House on November 29 would pay 90% of losses after $1 billion in aggregate industry losses or at lower levels of loss for individual insurers, to be paid back over time by assessments on insurers and, for large levels of loss, by surcharges on policyholders. The Committee believes that the thresholds for assistance in the House bill are too low and that the bill is excessively complex. The combination of low thresholds and potentially large assessments to be repaid over time might produce a long-term program.

The bill introduced by Senator Gramm would have the government pay 90% of losses above $10 billion each year for two years without a repayment feature. The Treasury could extend the program for a third year to cover losses above a $20 billion threshold. The Committee believes that the $10 billion threshold is more appropriate than the much lower amounts in the House bill and that a higher threshold would make sense for the second year. The Committee urges the Congress to develop an appropriate compromise that would incorporate the best features of both bills and otherwise reflect the principles set forth above.