A Proposed Federal Backstop for Terrorism Insurance and Reinsurance

Article

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For Information Contact:

Scott Harrington
(803) 777-4925
Peter J. Wallison
(202) 862-5864

Updated estimates of insured property and casualty losses from the destruction of the World Trade Center now total approximately $35 billion. In the weeks immediately following the attack on September 11, 2001, those losses and uncertainty concerning the future course of terrorism caused reinsurers around the world to threaten withdrawal of terrorism coverage. Primary property and casualty insurance companies indicated that, unless the government stepped in to provide last resort coverage, they would seek to exclude terrorism risk from new and renewal insurance contracts beginning in 2002. There was substantial concern that a shortage of terrorism coverage would have large spillovers on the availability of real estate lending and on new construction. In our prior statement on this subject, we suggested that insurance markets were beginning to digest the September 11th attack and 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."

Since that time the dire predictions of many observers have not come to pass. Insurers and reinsurers have raised over $30 billion in new capital with at least another $10 billion in new issues pending. Although primary insurers excluded terrorism coverage from their basic commercial property programs in the large majority of states that approved such exclusions, separate stand-alone coverage initially became available with total limits in the $250 million range. Limits as high as $1 billion are now available, and further increases in available limits are likely. While the prices of coverage are often high, the insurance brokerage community estimates that prices have declined by 50 to 75 percent since early in 2002, indicating that the market is adjusting. The availability of separate, stand-alone reinsurance for terrorism losses also has expanded since that time. Several catastrophe-modeling companies have developed, or are developing, models for use in forecasting terrorism losses, which should help insurers and reinsurers price and manage the risk.

Given the risk and cost, many businesses have opted not to buy terrorism coverage. Insuring the full value of certain high value, "trophy" properties remains problematic in New York and Chicago and a few other large cities, and some new construction has likely been impeded in those cities. There is no evidence, however, of any widespread reluctance of lenders to finance commercial property. The insurance, reinsurance, and lending markets have clearly made substantial progress in digesting the events of last September.

Our prior statement enumerated several principles that should underlie any federal backstop for terrorism insurance, most importantly:

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.
3. Intervention should avoid any direct government charge for assistance, which might lead to a long-term program, or government approval of premium rates.

Under the terrorism insurance bill approved by the House last November, the federal government would pay 90 percent 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. Our prior statement indicated that the House bill violated the second principle enumerated above: the thresholds for federal assistance are too low. We expressed our concern that the combination of low thresholds and potentially large assessments to be repaid over time might produce a long-term program.

In June 2002 the Senate enacted its backstop bill. Under the Senate bill, the federal government would pay 80 percent of losses above individual insurer retentions, which would likely equal roughly 7-8 percent of an insurer’s premiums. If industry losses reached $10 billion, the federal share would increase to 90 percent. The Committee believes that those thresholds also are too low. They would crowd out private sector coverage and impede efficient adjustments by insurers, lenders, developers, and other businesses exposed to the risk of loss from terrorism.

In conclusion, private insurance, reinsurance, and lending markets have made and are continuing to make substantial progress in adjusting to the

post-September 11 world. Given those developments, the case for a federal backstop for terrorism insurance, which was not clear-cut late last year, is certainly less compelling now. If some intervention is appropriate, the thresholds for government involvement should be materially higher than in either the House or Senate bills.