



The Heritage Foundation
Executive Memorandum

No. 790

November 15, 2001

A RESPONSIBLE SOLUTION FOR THE PROBLEMS FACING TERRORISM INSURANCE

DAVID C. JOHN

Without swift but well-considered action from Congress, thousands of American businesses may be unable to continue purchasing affordable terrorism insurance in the near future. The massive losses from the September 11 attacks have made property and casualty insurers understandably reluctant to issue policies with terrorism coverage until they can evaluate their exposure to potential terrorist attacks. Congress has an opportunity, in considering the Terrorism Risk Prevention Act (H.R. 3210), to structure a program that provides temporary assistance to private insurers while giving them an incentive to accurately risk-price their terrorism coverage against the threat.

In their effort to help victims of the attacks, however, Members of Congress should not shower insurance companies with unrestrained tax dollars, which would make matters worse by interfering with the market. The federal role in terrorism insurance must be temporary and limited. The last thing this country needs is another costly federal program like the flood insurance program that becomes permanent over time.

The Problem. Property and casualty insurers face a serious dilemma. Many of their corporate policies insure against terrorist attacks in much the same way they cover natural disasters or more conventional accidents. Insurance premiums are based on sophisticated estimates of the likelihood that a particular claim will have to be paid. Until September 11, insurers never expected to face the scale of damage inflicted in these attacks. Thus, terrorism

coverage often carried a very low price tag and often was included with more comprehensive coverage.

The world is different now. Insurers know that such attacks are possible and could cause catastrophic damage. But they have no firm idea whether the recent attacks were isolated incidents or not. As a result, they are unable to price terrorism coverage quickly and accurately, and unwilling to expose their companies to claims that could run in the tens of billions of dollars.

Losses from the recent attacks were spread among many foreign and domestic insurers and "reinsurers." This is standard practice for large policies; insurers essentially spread the risk among many other companies in return for a share of the premiums generated by the policies. Some of the risk is sold to reinsurers, who generally insure the insurance companies against huge losses. In this way, no one company is left facing ruin when there is a huge claim on a policy. This method enabled the industry to absorb the current \$35 billion in claims from the recent attacks on the World Trade

Produced by the
Domestic Policy Studies
Department

Published by
The Heritage Foundation
214 Massachusetts Ave., NE
Washington, D.C.
20002-4999
(202) 546-4400
<http://www.heritage.org>



This paper, in its entirety, can be found at: www.heritage.org/library/execmemo/em790.html

Center. A number of companies that would have difficulty paying another such loss are unwilling to renew policies that include terrorism coverage.

The Wrong Way to Address the Problem.

While the problem is real, it should be temporary; normal insurance industry processes should be able to resolve it. Over the course of a year or two, the industry should be able to develop ways to price terrorism coverage properly, which could include upper limits on company liability. And reinsurers should find ways to involve sophisticated investors who, for a price, could face the type of losses that could occur.

Such market responses take time, however, and some insurers are unwilling in the interim to renew policies with terrorism coverage. Failure to obtain affordable terrorism insurance could endanger the financing of some companies and the profitability of others. Rather than subject an already weakened economy to the shock of either no coverage or extremely high premiums, the government should take short-term action.

But the wrong government response could prevent the market from taking the necessary actions. Any program that essentially transfers the risk from companies to the government by promising that tax dollars will pay the losses will only make it more difficult for private insurers to establish the real market price for terrorism coverage. Because the industry would be collecting premiums without facing the true value of potential losses, such coverage would be underpriced. Those who bought this insurance would not have any incentive to reduce their risk, but every incentive to support extending the federal program indefinitely.

The result would likely be another federal insurance program with taxpayers permanently subsidizing the coverage and a federal role in terrorism insurance that is accompanied by increased government supervision and micromanagement. The federal flood insurance program, for example, now includes a host of environmental requirements.

A Responsible Approach. There is a way for Congress to create a responsible and temporary program that addresses the problem without distorting the market. Such a program must include these features, which are also found in H.R. 3210:

- **Maintain company retention of risk with escalating federal help for large claims.** Rather than have the government pay all terrorism-related claims, insurance companies should pay all claims up to a certain level. Above that level, the cost of claims should be shared with the government, perhaps on an escalating scale that increases the government proportion of larger claims. This feature gives companies the incentive to price terrorism coverage correctly. Legislation should be explicit about how the deductible is structured to ensure that both large and small companies are treated equally.
- **Require repayment of any tax dollars accepted.** Federal payments to insurers should be structured as loans to be repaid over time, perhaps through higher premiums on this line of insurance. This feature would give companies a strong incentive to price the policies properly and to end government involvement at the earliest opportunity.
- **Encourage companies to build reserves to cover future losses.** Legislation should include tax changes that encourage individual insurance companies to build sufficient reserves to cover potential claims. Such a move would allow the private sector to resume full control of terrorism coverage. Government policies should encourage companies to build their own reserves rather than force them to belong to and contribute to a national pool of reserves that could easily become a federal program.

Conclusion. The events of September 11 revealed the weaknesses in the current system of providing terrorism insurance. Rapid action needs to be taken to ensure that such coverage is still available. Rather than simply hand the industry tax dollars, Congress should structure a temporary program—a bridge through a time of uncertainty—that gives private companies every incentive to price terrorism insurance according to the risk without creating a permanent subsidy.

—David C. John is a Senior Policy Analyst in the Domestic Policy Studies Department at The Heritage Foundation.