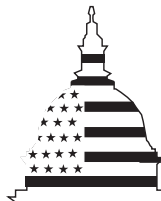


September 2008

# TERRORISM INSURANCE

## Status of Efforts by Policyholders to Obtain Coverage



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-08-1057](#), a report to congressional committees

## Why GAO Did This Study

The Terrorism Risk Insurance Act of 2002 (TRIA) specifies that the federal government assume significant financial responsibility for insured losses on commercial properties resulting from future terrorist attacks. While TRIA has been credited with stabilizing markets for terrorism insurance after the September 11, 2001, attacks, questions remain as to whether certain policyholders, especially those located in large urban areas viewed as being at high risk of attack, may still face challenges in obtaining coverage. GAO was asked to conduct a study to describe (1) whether the availability of terrorism insurance for commercial properties is constrained in any geographic markets, (2) factors limiting insurers' willingness to provide coverage, and (3) advantages and disadvantages of selected public policy options to increase the availability of such insurance.

To address these objectives, GAO analyzed available data and interviewed industry participants, including those with expertise in specific geographic markets considered to be at high, moderate, or low risk of attack (Atlanta, Boston, Chicago, New York, San Francisco, and Washington, D.C.).

GAO provided a draft of this report to the Department of the Treasury and the National Association of Insurance Commissioners (NAIC). Treasury and NAIC said the report was informative and useful.

To view the full product, including the scope and methodology, click on [GAO-08-1057](#). For more information, contact Yvonne D. Jones at (202) 512-8678 or [jonesy@gao.gov](mailto:jonesy@gao.gov).

# TERRORISM INSURANCE

## Status of Efforts by Policyholders to Obtain Coverage

### What GAO Found

While some owners of high-value properties in major cities may face initial challenges obtaining terrorism insurance coverage compared with most policyholders nationwide, they generally have reported that they could meet current coverage requirements through a variety of approaches. Many industry participants said that terrorism insurance is currently available nationwide at prices viewed as reasonable and that the TRIA program was a key reason for these favorable conditions. However, some policyholders that own large, high-value properties in densely built urban areas viewed as at high risk of attack, particularly in Manhattan and to a lesser extent in Chicago and San Francisco, may still face initial challenges obtaining desired amounts of coverage at prices viewed as reasonable, according to industry participants. To address these challenges, some policyholders purchased coverage from a large number of insurers, which can be a time-consuming and complicated process for policyholders and their insurance brokers. Others purchased coverage in a separate policy (rather than as part of an overall property insurance package) which may be more costly, or self-insured.

While TRIA specifies that the federal government assume substantial financial responsibility for insured losses associated with future terrorist attacks, the steps insurers take to manage the risks they do face appear to be the primary reason some policyholders face challenges in obtaining coverage. Insurers said they seek to mitigate potential terrorism losses by limiting the amount of property coverage that they offered in specific areas of cities, such as downtown locations or areas considered to be at high risk of attack. These risk mitigation efforts generally make obtaining coverage more difficult or costly for policyholders with high-value properties in these areas, according to a variety of sources GAO contacted. Industry participants also said that the availability of reinsurance (insurance for insurers) and the views of rating agencies can limit the availability of coverage in such cities.

Industry participants had no consensus on whether TRIA should be modified or additional actions taken to increase the availability of terrorism coverage, and identified advantages and disadvantages of selected policy proposals that have been included in legislation, discussed in prior GAO reports, or suggested by industry participants to increase such coverage. A proposal to increase the federal government's current responsibility under TRIA for the insured losses associated with a future attack could make insurers more willing to offer coverage in affected areas. For example, one large insurer said that the proposal might make the company more willing to immediately offer additional coverage in cities viewed as at high risk of attack. However, any such benefits might be limited for reasons including the widespread insurance market disruptions that may result from another attack. This proposal, along with several other proposals analyzed in the report, also would increase the federal government's exposure to the losses associated with terrorist attacks, which is already 85 percent of losses up to \$100 billion annually, after an industry deductible.

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## **Abbreviations**

FHCF	Florida Hurricane Catastrophe Fund
ISO	Insurance Services Office
NAIC	National Association of Insurance Commissioners
Pool Re	Pool Reinsurance Company, Limited
REMIC	Real Estate Mortgage Investment Conduits
SFP	Standard Fire Policy
TRIA	Terrorism Risk Insurance Act

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United States Government Accountability Office  
Washington, DC 20548

September 15, 2008

The Honorable Christopher J. Dodd  
Chairman  
The Honorable Richard C. Shelby  
Ranking Member  
Committee on Banking, Housing, and Urban Affairs  
United States Senate

The Honorable Barney Frank  
Chairman  
The Honorable Spencer Bachus  
Ranking Member  
Committee on Financial Services  
House of Representatives

The terrorist attacks of September 11, 2001, are estimated to have resulted in insured losses amounting to \$32.5 billion, as of 2006.<sup>1</sup> Subsequent to the attacks, insurers largely stopped offering terrorism insurance coverage to commercial property owners, which raised significant concerns about potential negative economic consequences. For example, existing real estate development projects faced delays and cancellations following September 11 because they could not get terrorism coverage, which led to concerns that the economy, which was already suffering as a result of the attacks, would further deteriorate. To help restore confidence and stability in property insurance markets, Congress enacted and the President signed the Terrorism Risk Insurance Act of 2002 (TRIA).<sup>2</sup> Under TRIA, insurers generally are required to offer terrorism insurance to their commercial clients on the same terms they offer other types of insurance, and, in the event of a future terrorist attack, are responsible for paying a deductible of 20 percent of their direct earned premiums from the previous year to cover

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<sup>1</sup>Department of the Treasury, Board of Governors of the Federal Reserve System, U.S. Securities and Exchange Commission, and Commodity Futures Trading Commission, *Terrorism Risk Insurance: Report of the President's Working Group on Financial Markets* (Washington, D.C., September 2006), 8.

<sup>2</sup>Pub. L. No. 107-297, 116 Stat. 2322 (Nov. 26, 2002).

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related losses.<sup>3</sup> The federal government is responsible for covering 85 percent of the insured losses up to a maximum of \$100 billion on an annual basis after insurance companies pay the deductible. While TRIA, which was reauthorized in 2005 and again in 2007, generally has been credited with stabilizing markets for commercial property insurance, some building owners, Members of Congress, and others remain concerned that there may still be gaps in coverage.<sup>4</sup> In particular, they have expressed concerns about the ability of policyholders that are located in large urban areas viewed as being at high risk of attack to obtain terrorism insurance coverage.

To assist the committees in their oversight efforts of the insurance industry, you asked that we conduct a study to determine if specific markets in the United States have any unique constraints on the amount of terrorism insurance available and evaluate options to enhance coverage. As agreed with your staff, we are providing a report that describes (1) whether the availability of terrorism insurance for commercial properties is constrained in any geographic markets and the effect of any constraints on pricing and coverage amounts, (2) factors limiting insurers' willingness to provide coverage, and (3) advantages and disadvantages of some public policy options to increase the availability of property terrorism insurance.<sup>5</sup>

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<sup>3</sup>Department of the Treasury regulation codified at 31 C.F.R. § 50.5(d) defines direct earned premiums as a direct earned premium for all commercial property and casualty insurance issued by any insurer for insurance against all losses, including losses from an act of terrorism, occurring at locations within the United States, or on U.S. air carriers or U.S. flag vessels, or at the premises of any U.S. mission. The Department of the Treasury provided further clarification that direct earned premiums are "earned as reported to the NAIC in the Annual Statement in column 2 of Exhibit of Premiums and Losses (commonly known as Statutory Page 14)" and cover all risks, not only for risks from terrorism. The NAIC is the National Association of Insurance Commissioners, which is an organization representing state insurance regulators.

<sup>4</sup>See Terrorism Risk Insurance Extension Act of 2005, Pub. L. No. 109-144, 119 Stat. 2660 (Dec. 22, 2005) and Terrorism Risk Insurance Program Reauthorization Act of 2007, Pub. L. No. 110-160, 121 Stat. 1839 (Dec. 26, 2007).

<sup>5</sup>Under the 2007 statute that reauthorized TRIA coverage, GAO was required to report to Congress on similar objectives by June 23, 2008. See 15 U.S.C. § 6701 note (Terrorism Insurance Program § 108(g)(3)). To satisfy this mandate, we made presentations to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate on June 20 and June 23, 2008, respectively. The presentation, GAO, *Initial Results on Terrorism Insurance Availability in Specific Geographic Markets*, GAO-08-919R (Washington, D.C.: July 11, 2008) is available on GAO's Web site at <http://www.gao.gov>. This report is based largely on our prior work. However, we added additional information and analysis, including information on two additional public policy options that were not discussed in our prior work.

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To assess whether the availability of terrorism insurance for commercial properties is constrained in any geographic markets, we compiled and analyzed available data on insurance and reinsurance companies, terrorism insurance take-up rates, and terrorism insurance pricing.<sup>6</sup> We also interviewed more than 100 industry participants with nationwide perspective and expertise in specific geographic markets, including Atlanta, Boston, Chicago, New York, San Francisco, and Washington, D.C. We selected these high-, moderate-, and low-risk markets based on an industry analyst's ranking of cities by risk of terrorism. Our interviews included insurer and policyholder trade associations, policyholders in a variety of industries, national and regional insurance and reinsurance brokers, insurance and reinsurance companies, and state regulators. To identify the factors that may contribute to insurers' willingness or ability to provide terrorism insurance coverage, we selected large, national insurance companies to interview based on their market share in the states we studied. These national insurance companies held from 37 to 52 percent of the market share in the states we studied. In addition, we interviewed representatives of regional insurance companies in our selected markets. We also spoke with risk modeling firms and credit rating agencies. To obtain views on the advantages and disadvantages of some public policy options that have been proposed in legislation, discussed in our prior reports, or suggested by industry participants to increase insurers' capacity (that is, their willingness or ability) to provide terrorism coverage, we relied on our interviews with industry participants described above. We also interviewed academics who have written on the topic of terrorism insurance, research organizations, and consumer interest groups. Although we selected industry participants to provide broad representation of market conditions geographically and by industry, the number of participants may not necessarily be representative of the universe of insurers, insurance brokers, policyholders, and regulators. As a result, we could not generalize the results of our analysis to the entire national market for commercial property terrorism insurance. Appendix I contains additional details of our objectives, scope, and methodology.

We conducted our audit in California, Georgia, Illinois, Massachusetts, New York, and Washington, D.C., from January 2008 to September 2008, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence

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<sup>6</sup>Reinsurance companies provide insurance to insurers.

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obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Results in Brief

While some owners of high-value properties in major cities may face initial challenges obtaining desired amounts of terrorism coverage compared to most policyholders nationwide, they generally have reported being able to meet their current coverage requirements through a variety of approaches. Many industry participants and policyholders said that terrorism insurance currently is available nationwide at prices viewed as reasonable, and they cited the TRIA program and the current “soft,” or competitive, insurance market for these generally favorable conditions. However many industry participants also said that certain policyholders, especially those seeking large policies in areas viewed as at higher risk of terrorist attack, may face initial challenges obtaining full coverage for terrorism at rates viewed as reasonable. According to policyholders and brokers, these policyholders typically own large, high-value properties such as office towers or hotels in urban areas where many large buildings are clustered and that are viewed as at high risk of attack, particularly in Manhattan, and to a lesser extent certain areas of other major cities such as Chicago and San Francisco. To address these challenges and satisfy their current coverage requirements, policyholders and insurance brokers we contacted reported adopting one or more of several different approaches. For example, some policyholders purchased coverage from a larger number of insurers in complex insurance programs, adding to what can be a time-consuming and complicated process for the policyholders and their brokers. Moreover, some policyholders purchased coverage in a separate terrorism-only policy (rather than including the coverage in their standard all-risk property insurance package) for a portion or all of their insurance needs, which may be more costly than the traditional approach. Other policyholders, typically large corporations, self-insured a portion or all of their terrorism coverage requirements through what are known as “captive” insurance companies that have been set up to insure the risks of their owners.

While TRIA limits insurers’ financial exposure in future terrorist attacks, several insurers said they remained concerned about the exposure they retained, and their efforts to minimize potential losses appear to be a primary reason why some policyholders faced challenges in obtaining coverage. Insurers said they seek to mitigate potential losses from a single terrorism attack by limiting the amount of property coverage that they offer in specific areas of cities, such as downtowns or financial districts where many large buildings are clustered, or other areas considered to be at high risk of attack, such as parts of Manhattan. These exposure limits,



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referred to here as aggregation limits, generally make obtaining coverage more difficult or costly for certain policyholders in these areas, according to a variety of sources we contacted. For instance, an insurer could decline to cover a property in a certain area, offer a lower coverage amount, or charge a higher premium rate. Industry participants also said the limited availability of reinsurance (insurance for insurers) and the views of credit rating agencies can affect the availability and cost of terrorism insurance in cities viewed as at high risk of attack. Reinsurers we contacted said that they also have established aggregation limits in certain cities to mitigate their risks, and rating agency officials said that their credit ratings for insurers often depend, in part, on their ability to manage the potential losses associated with terrorist attacks in major urban areas.

Insurance industry participants and analysts we contacted had no consensus on whether TRIA should be modified or additional actions taken to increase the availability of terrorism insurance coverage. They also identified advantages and disadvantages of various policy proposals that have been made in legislation, discussed in our prior reports, or suggested by industry participants to increase terrorism coverage. For example, one recent legislative proposal involves lowering the TRIA deductible to 5 percent (from 20 percent) for insurers experiencing losses from a future terrorist attack that results in more than \$1 billion in damages. Supporters of this proposal argue that lowering the TRIA deductible could make insurers more willing to offer coverage following an attack, which would stabilize insurance markets in affected areas and facilitate rebuilding and recovery efforts. In addition, a large insurer said that the legislative proposal, if adopted, might make it immediately more willing to offer terrorism insurance coverage to policyholders in certain cities where some policyholders currently face initial challenges in obtaining coverage. While not necessarily opposed to the proposal, other industry participants and analysts cautioned that its effects may be limited. For example, they said that several large insurers already seek to manage their potential losses from a potential terrorist attack, through aggregation limits, to levels well below the current TRIA deductible of 20 percent. As a result, even lowering the deductible to 5 percent would not necessarily result in a significant increase in the coverage offered by such insurers. Further, insurance market disruptions associated with another terrorist attack could limit the supply and cost of coverage even if the federal government assumed greater responsibility for such losses. Industry participants also identified both advantages and disadvantages associated with other proposals to increase terrorism insurance availability. The proposals are: permitting insurers to establish tax-deductible reserves for terrorism-related losses, forming a group of insurers

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to pool assets for terrorism risks, facilitating the use of catastrophe bonds for terrorism through amendments to the federal tax code, and limiting certain state regulation of property insurance premiums or amending coverage requirements. We note that while several of these proposals (for example, establishing tax-deductible reserves) might enhance the availability and price of terrorism coverage, any such effects likely would take place over the longer term and not immediately address challenges that certain policyholders initially may face in obtaining coverage. Further, all of the proposals, except amending state regulations, also could increase the federal government's exposure to potential terrorism-related losses or otherwise reduce federal revenues.

We provided a draft of this report to the Department of the Treasury and the National Association of Insurance Commissioners (NAIC) for their review and comment. In oral comments, Department of the Treasury and NAIC officials said that they found the report informative and useful. They also provided technical comments that were incorporated where appropriate.

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## Background

TRIA requires private insurers to offer terrorism coverage in commercial property and casualty insurance, including workers' compensation insurance policies. Insurers must make terrorism coverage available to their policyholders on the same terms and conditions, including coverage levels, as other types of insurance coverage. For example, an insurer offering \$100 million in commercial property coverage must offer \$100 million in coverage for property damage from a certified terrorist attack.<sup>7</sup> However, insurers could impose an additional charge for the coverage and policyholders, except in workers' compensation policies, generally have the option of not purchasing it.

Under TRIA, the federal government is to reimburse insurers for a portion of their losses from certified terrorist acts. Specifically, the federal

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<sup>7</sup>TRIA defines an "act of terrorism" as any act that is violent or dangerous to human life, property, or infrastructure and is certified as an act of terrorism by the Secretary of the Treasury, in concurrence with the Secretary of State, and the Attorney General of the United States, which has resulted in damage within the United States, or outside of the United States in the case of an air carrier or vessel (as defined for purposes of TRIA) or to the premises of a U.S. mission, and was committed by an individual or individuals, as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the U.S. government by coercion. Acts of war and losses that in the aggregate do not exceed \$5,000,000 are specifically excluded. *See* 15 U.S.C. § 6701 note (Terrorism Insurance Program § 102(1)).

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government would reimburse insurers for 85 percent of their losses after the insurers pay a deductible amounting to 20 percent of the previous year's direct earned premiums.<sup>8</sup> The federal funding is activated when aggregate industry losses exceed \$100 million and is capped at an annual amount of \$100 billion.<sup>9</sup>

Originally enacted as a 3-year program, Congress has reauthorized the program twice and recently extended it until 2014. In December 2005, Congress passed the Terrorism Risk Insurance Extension Act that increased the required amount insurers would have to pay in the aftermath of a terrorist attack. In December 2007, Congress approved the Terrorism Risk Insurance Program Reauthorization Act and eliminated the distinction between terrorist acts carried out by foreign and domestic actors. It also clarified language on insurers' liability, stating that insurers are not responsible for losses that exceed the federal government's annual liability cap of \$100 billion.<sup>10</sup>

Commercial property insurance policies can be simple or complex, depending on the value and location of the properties being insured. Property owners may insure properties individually or consolidate multiple properties in a portfolio and insure them with a single policy. The benefits of grouping properties include spreading the cost (premium) across more than one building on the premise that all buildings in a portfolio are unlikely to be damaged by the same peril in the same event. Policies with high insured values can require multiple insurers to provide coverage, with each providing a portion of the coverage up to the full amount of the policy, because the total insured value is too great for any one insurer to absorb (see fig. 1). According to a representative of a large brokerage firm, policyholders typically buy property coverage, including terrorism coverage, through one all-risk policy, which insures losses from multiple perils.

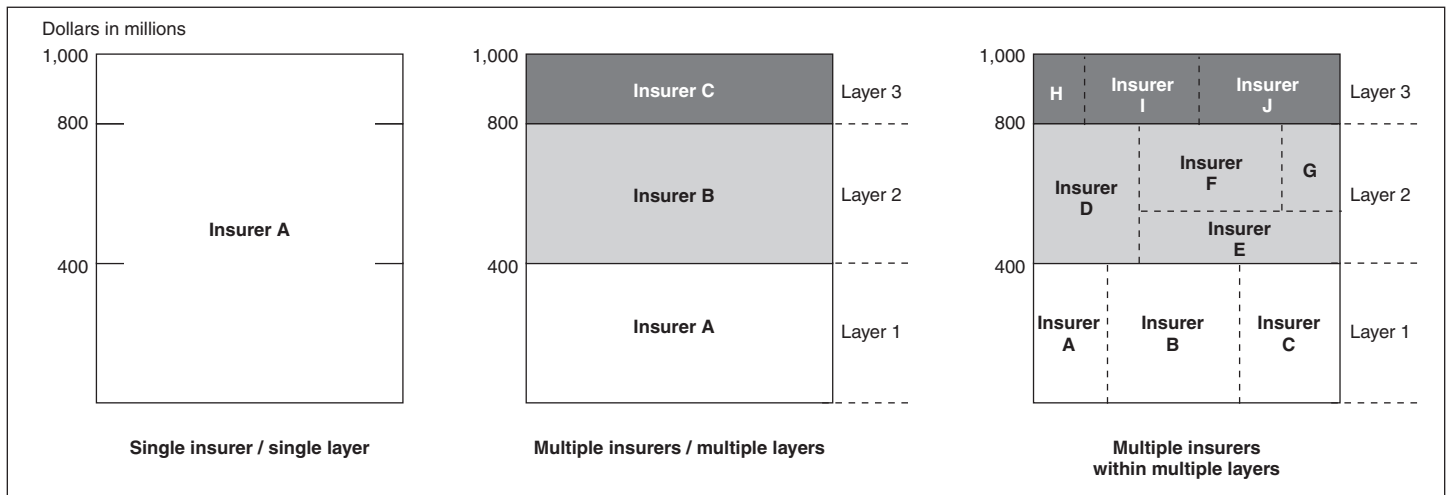
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<sup>8</sup>15 U.S.C. § 6701 note (Terrorism Insurance Program §§ 102(7)(F) and 103(e)(1)(A)).

<sup>9</sup>15 U.S.C. § 6701 note (Terrorism Insurance Program § 103(e)).

<sup>10</sup>See 15 U.S.C. § 6701 note (Terrorism Insurance Program § 103(e)(2)(A)(ii)).

**Figure 1: Examples of Structuring Options for Commercial Property Insurance**



Source: GAO.

Policyholders generally do not purchase terrorism insurance in amounts that would cover the total replacement value of the insured property, but rather purchase insurance in amounts that reflect the maximum amount of foreseeable losses that could occur in a terrorist attack. Also, policyholders may determine the amount of terrorism coverage to purchase based on amounts required by a lender providing the mortgage on the property.

States have primary responsibility for regulating the insurance industry in the United States, and state insurance regulators coordinate their activities in part through the NAIC. The degree of oversight of insurance varies by state and insurance type. In some lines of insurance, insurers may file insurance policy forms with state regulators that help determine the extent of coverage provided by a policy by approving the wording of policies, including the explicit exclusions of some perils. According to a NAIC representative, while practices vary by state, state regulators generally regulate prices for personal lines of insurance and workers' compensation policies but not for commercial property/casualty policies. In most cases, state insurance regulators perform neither rate nor form review for large commercial property/casualty insurance contracts because it is presumed that businesses have a better understanding of insurance contracts and pricing than the average personal-lines consumer. Reinsurers generally are not required to get state regulatory approval for the terms of coverage or the prices they charge.

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## Terrorism Insurance Generally Is Available Nationwide, although Some Policyholders Had to Take Additional Steps to Obtain Coverage

According to a variety of sources, commercial property terrorism insurance currently appears to be widely available on a nationwide basis at rates viewed as reasonable, largely due to the TRIA program and the current “soft” insurance market. However, some policyholders in urban areas viewed as being at higher risk of a terrorist attack, particularly in Manhattan and to a lesser extent in some other high-risk cities such as Chicago and San Francisco, may be forced to take additional steps to overcome challenges they may have initially faced in obtaining desired amounts of coverage at prices viewed as reasonable. Policyholders generally have been able to obtain desired or required amounts of terrorism coverage by increasing the number of carriers in what already may be large and complex insurance programs, adding to what can be a time-consuming and complicated process for policyholders and their insurance brokers. Others secure needed coverage by purchasing all or a portion of their terrorism coverage in a separate insurance policy, or self-insuring through a captive insurance company.

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## Terrorism Insurance Generally Is Available Nationwide at Rates Viewed as Affordable Largely Due to the TRIA Program and the Soft Insurance Market

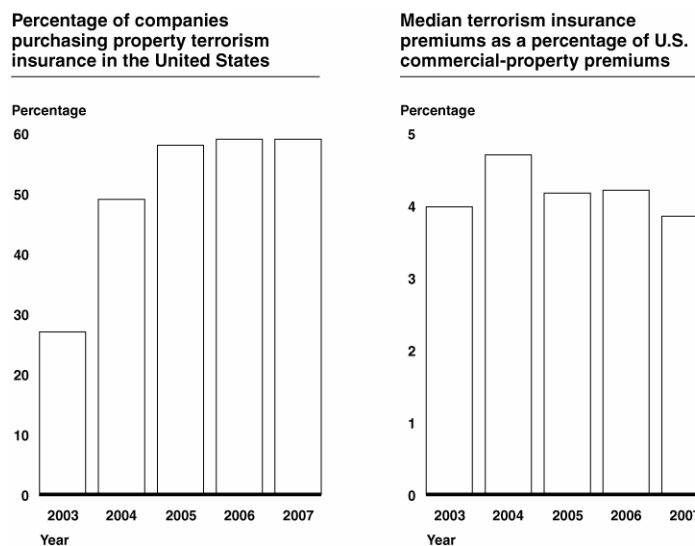
According to data compiled by two large insurance brokers, a majority of their commercial clients nationwide purchase terrorism insurance coverage, and the premium rates for such coverage generally have been stable in recent years. As shown in figure 2, one of these brokers reported that approximately 60 percent of its clients purchased some form of terrorism coverage each year from 2005 through 2007. Another large insurance broker reported that take-up rates for its large property clients have remained between 60 percent and 65 percent since 2004. According to a large broker, the Northeast, which includes New York City, has the largest percentage of companies that purchase terrorism coverage for properties, with about 70 percent having purchased it in 2007.<sup>11</sup> Real estate companies account for the largest percentage of clients that purchased terrorism insurance coverage, with more than 80 percent of these clients having done so in 2007. Manufacturing and construction companies had the lowest purchase rates, with 45 percent and 34 percent, respectively, having purchased coverage in 2007. Data collected by one of these large brokers also show that the premiums that their clients paid for terrorism coverage, expressed as a percentage of the commercial property

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<sup>11</sup>Representatives of this broker noted that these data are limited because locations are typically recorded where the client is headquartered, not necessarily where the insured properties are located. For example, a company headquartered in New York City would be included in New York even if the vast majority of the company’s property holdings are located elsewhere.

premiums, generally have been stable at around 4 percent since 2003 (fig. 2). Another large broker also reported that premiums have been stable at around 4 percent, on average, since 2006.

**Figure 2: Purchase and Cost Rates of Property Terrorism Insurance**



Source: GAO analysis of data from Marsh & McLennan Companies.

An official from one of these brokerages told us steady purchase rates between 2005 and 2007 may indicate that policyholders who want to purchase terrorism coverage have been able to purchase it. According to representatives from these two brokers, the primary reason why approximately 40 percent of clients did not purchase terrorism coverage is that they may not have perceived themselves at risk of a terrorist attack, particularly those in nonurban areas or those in industries perceived to be at lower risk of attack, such as manufacturing. Other reasons clients may not have purchased coverage include the absence of lender requirements or the cost of coverage, according to one large broker.<sup>12</sup>

Information we collected in a range of interviews with policyholders, national and regional brokers, insurers, and others was consistent with the view that terrorism insurance coverage is available nationwide at premium

<sup>12</sup>According to a national trade association representing lenders, commercial real estate lenders typically require that terrorism insurance be included as part of the mortgaged property's all-risk insurance policy and that property insurance, including terrorism coverage, is maintained for the property for the duration of the loan.

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rates viewed as reasonable. Several policyholders we contacted that own large and small portfolios of real estate throughout the United States, including national hotel chains, sports stadiums, office towers, shopping malls, and residential buildings, told us they could obtain as much terrorism coverage as they sought to obtain. Some policyholders and regional brokers also said that terrorism insurance premiums continue to decline while the quality of coverage improves. For example, a representative from a commercial real estate company that owns large office towers, a luxury resort, and an industrial property in major U.S. cities said the company recently increased its terrorism coverage by more than 50 percent and decreased its premium by more than 20 percent. In at least one state, an insurer and state regulator told us terrorism coverage may be provided at no additional cost to policyholders, especially those with properties perceived to be at low risk of a terrorist attack.

Insurers, policyholders, and other industry participants cited the TRIA program and the current soft, or competitive, market as the key reasons that terrorism coverage generally has been available nationwide. Without the federal backstop for potential insurance losses related to terrorism, industry participants said that coverage availability could decline substantially. For example, some insurers told us the amount of terrorism coverage they provide would decline—by more than 95 percent for one insurer—without the TRIA provision that provides reimbursement for insured losses that exceed the amount of an insurer’s TRIA deductible. In a soft market, insurance is widely available and sold at a lower cost, making it easier for buyers to obtain insurance. According to insurance industry participants, recent strong profits, increases in investment income, and a lack of large losses from major catastrophes have contributed to insurers’ ability to increase their capital levels in recent years. According to some brokers, high levels of capital have increased insurers’ capacity and willingness to provide terrorism insurance coverage.

However, some interviewees cautioned that another terrorist attack or “hardening” of the general terrorism insurance market could reduce the current supply of terrorism insurance coverage and increase pricing. In the past, insurers frequently have responded to catastrophic events by cutting back coverage significantly or substantially increasing premiums for policyholders. For example, such reactions took place in the Florida market after Hurricane Andrew in 1992, in California after the Northridge earthquake of 1994, and more widely following the September 11 attacks. A broker with a large national firm told us that the insurance industry has remained highly sensitive to the potential financial consequences of

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another terrorist attack since September 11. According to one industry analyst, even a modest terrorist attack in the future could cause significant fear and concern in the market and lead to increases in prices and restrictions on availability. Moreover, some industry analysts said that insurers could suffer significant losses for a variety of other reasons, such as the costs of a large hurricane or earthquake or declines in the values of their investment portfolios, which might make them less willing to offer terrorism coverage under current terms and pricing.

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### Some Policyholders in Major Cities Have Faced Initial Challenges in Obtaining Desired Terrorism Coverage at Rates Viewed as Favorable

While terrorism insurance coverage generally is available nationwide, many industry participants reported that some policyholders in major cities viewed as being at higher risk of terrorist attack, particularly in Manhattan, may initially experience challenges in obtaining desired amounts of coverage.<sup>13</sup> Specifically, industry participants said that owners of large, high-value properties in financial districts or downtown locations, or near government offices or transit hubs, may face initial challenges in obtaining coverage in their all-risk property policies. For example, a policyholder with large office and retail properties in New York, San Francisco, and Chicago told us only a few insurers were willing to offer it coverage that it considered expensive and that provided only half of the \$1.5 billion in coverage sought. In spite of these initial challenges, this policyholder was able to obtain the needed coverage by taking other approaches that will be discussed later in this report.

Brokers and policyholders mentioned these difficulties have been more severe in certain locations in Manhattan than anywhere else. In particular, they said the area surrounding Times Square—or midtown—and lower Manhattan, which contained the World Trade Center, presents difficulties because of the dense concentration of buildings, perceived risk of a future terrorist attack, and the overlapping insurance needs of building owners and tenants. For example, one broker active in the New York market told us of an approximately 15-block stretch of midtown Manhattan with a high concentration of property values in which each property is valued at \$1 billion or more, creating strong demand by building owners for limited and expensive coverage. Another broker told us the availability of terrorism coverage is most constrained in the area surrounding the World Trade

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<sup>13</sup>According to a national insurer trade association, insurance policies are typically in force for a 1-year period. The process of putting an insurance contract out for bid or negotiating new terms and conditions of the contract can take several months.



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Center site in lower Manhattan. The brokers said retail clients that would like to establish themselves in this area worry about not enough coverage being available for terrorism, flood, and fire damage.

Representatives from large national brokers, as well as insurance companies and other industry participants, said that certain policyholders in Chicago and San Francisco also may face initial challenges in obtaining terrorism insurance coverage, although to a lesser extent than in Manhattan. As is the case in Manhattan, these policyholders typically own large buildings in proximity to other buildings and generally are located in financial districts or downtown locations. While owners of large buildings in such locations may face challenges in obtaining coverage, a broker told us that even a small building might be difficult to insure for terrorism risk if it were located near larger properties in high-risk areas.

Many industry participants reported that premiums were higher in cities considered to face greater financial risks from the likelihood of terrorist attacks occurring there, adding to the challenge of obtaining terrorism coverage. For example, according to one large insurance broker, terrorism insurance premiums in New York City can be twice as high as prices for similar buildings in other cities considered to be at high risk of a terrorist attack, and more than five times higher than prices in lower-risk cities. The premium amount dedicated to insuring properties in certain locations against terrorism risks may, on a relative basis, significantly exceed the amount necessary to cover such risks in other geographic areas. For example, a broker in the San Francisco Bay area told us average terrorism pricing for owners of certain buildings there can be from 20 to 30 percent of the all-risk property premium, whereas the national median was around 4 percent in 2007.

While some policyholders in high-risk cities face challenges, we note that this is not necessarily the case in all such cities. In particular, policyholders we contacted with properties in Washington D.C. said while it may have been difficult or more expensive to obtain terrorism coverage immediately following September 11, coverage is now readily available and affordable. For example, policyholders we interviewed that own properties in the city said they were able to include full terrorism coverage in their all-risk property policies even though they own or manage commercial and residential properties in proximity to potential targets such as the White House, the Capitol, subway stops, or foreign embassies. Industry participants said that policyholders generally experience fewer challenges in Washington, D.C. because the buildings are not as high or as densely concentrated as in downtown areas of other high-risk cities.

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To Obtain Full Terrorism Coverage, Policyholders May Add Additional Carriers to Existing Insurance Programs, Purchase Terrorism-only Policies, or Self-Insure

Policyholders that have experienced initial difficulty obtaining terrorism coverage in their primary all-risk property policies generally have been able to meet current terrorism insurance requirements by one of several approaches or a combination thereof, according to industry participants. For example, some policyholders and brokers reported obtaining coverage from a greater number of insurers in what may already have been a complex insurance program. As discussed earlier, policies with high insured values can require multiple insurers to provide portions of coverage up to the full amount of the policy. However, a few policyholders told us more insurers are now required to assemble terrorism coverage because insurers are taking smaller amounts of risk (that is, offering smaller amounts of coverage), requiring a greater number of insurers to fill out an insurance program and adding to what can be a time-consuming and complicated process for policyholders and their insurance brokers. Some policyholders said more than 20 insurers may participate in a single insurance program. One policyholder told us more than 40 insurers participate in its property insurance policy. Layering an insurance program has costs, especially for large and complex programs. A representative of a large hotel chain told us that layering insurance is “painful” because of the effort involved in convincing insurers to become comfortable with a risk.

Moreover, several brokers and policyholders reported purchasing property terrorism insurance in a stand-alone policy to cover portions or all of the required coverage.<sup>14</sup> For example, the owner of multiple large office buildings in Manhattan’s midtown and downtown financial districts told us the company purchased all of its terrorism coverage as a stand-alone insurance policy because it could obtain just half of the \$800 million in coverage sought. Another policyholder that owns a nationwide chain of hotels, with properties in Manhattan, Chicago, and San Francisco, decided to purchase all of its terrorism coverage in a stand-alone policy to avoid the high and inconsistent cost of embedding terrorism coverage in its all-risk policy. A representative of this policyholder noted that cost was a particular issue following the 2005 hurricane season when property insurance prices generally increased. Some policyholders told us stand-alone terrorism coverage was more expensive than obtaining coverage as part of an all-risk property policy. However, data from a national broker show that the difference in pricing between stand-alone coverage and

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<sup>14</sup>A stand-alone terrorism insurance policy limits coverage to losses from terrorist attacks, in contrast to an all-risk policy that would cover losses from multiple risks or perils.

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coverage included in an all-risk policy was small for most of 2007, with the median price for stand-alone coverage at 5 percent of the overall property premium compared to around 4 percent for coverage in the all-risk program.

Finally, according to brokers and policyholders some policyholders have used self-insurance as a means to assemble coverage. That is, they placed all or a portion of their terrorism coverage in a captive insurance company, which insures the risks of the owner.<sup>15</sup> For the purpose of insuring property terrorism risk, a captive insurer would generally be a wholly owned insurance company within the corporate structure of the property owner. The typical owners of captives used for insuring terrorism risk are large corporations that own large or well-known buildings in major urban areas and have not been able to obtain coverage through other means. For example, a policyholder we contacted sought to obtain \$1.2 billion in property coverage for multiple buildings in Manhattan, including terrorism coverage, which would cover the total replacement cost of the largest building in its portfolio.<sup>16</sup> However, a representative of this policyholder told us the company could obtain just \$500 million of all-risk property insurance that included terrorism coverage, leaving a gap of \$700 million in coverage for terrorism risk. The policyholder considered filling the gap by obtaining terrorism coverage in the form of a more expensive stand-alone insurance policy, but decided instead to establish a captive insurance company to supplement the coverage provided in the all-risk policy and make up the \$700 million difference. Another

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<sup>15</sup>Captive insurance companies provide value to large corporations using them for terrorism coverage. Under TRIA, insurers required to participate in the program are defined as entities “licensed or admitted to engage in the business of providing primary or excess insurance in any state.” See TRIA Section 102(6). Because captives are licensed and admitted by the states, just like traditional insurance companies, captives are “insurers” under TRIA and participate in the program. Captives receive compensation for insured losses under the program, enabling captive owners to transfer a significant portion—85 percent—of their terrorism exposure to the federal government for qualifying terrorist attacks, after paying a deductible. Captives also have direct access to the private reinsurance market, enabling captive owners to transfer a portion of their exposure to private insurers, according to a reinsurer and captive manager. Finally, policyholders can reduce their insurance costs by creating captive insurers and setting premium rates according to their own claims experience. However, there are significant costs to establishing and maintaining captive insurers, as well as the possibility of the parent company experiencing significant financial losses.

<sup>16</sup>Policyholders generally determine the amount of coverage to purchase based on lender requirements or the amount of losses that could result in a terrorist attack, which for some is the total replacement cost of the largest building in a portfolio.

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policyholder with a lender requirement to purchase about \$1.6 billion in coverage on a single building in midtown Manhattan was unable to obtain sufficient terrorism coverage in an all-risk policy in 2008. This policyholder purchased an all-risk policy that excluded terrorism risk and assembled property coverage for terrorism risk in the form of a \$250 million stand-alone policy and about \$1.3 billion in a newly formed captive insurance company. Although these examples show policyholders may create captive insurance companies for the sole purpose of insuring terrorism risk, this approach may not be typical of the way in which captives are used.<sup>17</sup> Representatives of two large insurance brokers said most companies simply add terrorism risk to captives that already have been established to cover other insurance risks, such as environmental and product-recall risks.

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## Insurer and Reinsurer Efforts to Mitigate Their Risks Appeared to Be Why Certain Policyholders Faced Initial Challenges in Obtaining Terrorism Insurance Coverage

While TRIA limits insurers' potential losses from a terrorist attack, the efforts of insurers' to manage the remaining risks they faced appeared to be the primary reasons for certain policyholders experiencing initial challenges in obtaining desired amounts of coverage at prices they viewed as reasonable. To mitigate their risks, many insurers set limits on the amount of coverage that they would provide to policyholders in confined geographic areas within a city, such as downtown locations or financial districts where many large buildings are clustered, or in specific areas of cities considered to be at high risk of attack. According to a variety of sources we contacted, these limits generally make obtaining coverage more difficult or costly for certain policyholders in these areas. Further, industry participants and analysts said that the availability of reinsurance and the views of credit rating agencies also may limit the supply and increase the price of terrorism insurance coverage in certain high-risk cities.

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<sup>17</sup>In a September 2004 letter interpreting its implementation of TRIA, the Department of the Treasury raised questions regarding the integrity of forming or utilizing captive insurers to only provide stand-alone, single-risk TRIA-only coverage for losses from acts of terrorism. In this letter, the department explained that it would continue to monitor developments in the market for terrorism risk insurance to determine if future rulemaking is needed to address the role of captives under TRIA. The letter stated that the Department of the Treasury has concerns about the possibility that captives may be used as a tool for avoiding the program's requirements and deductible because captives providing stand-alone terrorism coverage would be able to access reimbursements through TRIA at a much lower level than other insurers writing multiple lines of insurance. This is because the deductible is calculated on all lines of coverage written, not only coverage for terrorism. The department's letter is online at [http://www.treas.gov/offices/domestic-finance/financial-institution/terrorism-insurance/pdf/0924\\_2.pdf](http://www.treas.gov/offices/domestic-finance/financial-institution/terrorism-insurance/pdf/0924_2.pdf).

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Insurers' Concerns about  
Amounts of Future  
Terrorism Losses Influence  
Their Willingness to  
Provide Coverage,  
Affecting Availability and  
Price in Certain Cities

Representatives from several insurance companies we contacted said that despite the TRIA financial backstop, they remain significantly concerned that a future terrorist attack would result in substantial losses. In the event of another terrorist attack, industry participants said that certain large insurers may face TRIA deductibles that would result in losses of billions of dollars. For example, one of the largest insurers providing commercial property coverage would face a \$5 billion TRIA deductible based on 2007 data. The representative of one large insurer said that the company's TRIA deductible was three times the net losses the company suffered due to the September 11 attacks. Furthermore, even a terrorist attack that caused losses below the \$100 million TRIA program trigger could cause substantial losses to a small insurer. For example, the company surplus might be exhausted from paying the entire loss, according to the representative of a small insurer.<sup>18</sup>

Insurers said that they seek to mitigate potential losses from a single terrorism attack by limiting the amount of property coverage that they offer in confined geographic areas within cities. For example, some insurers told us that they would not insure certain types of properties, buildings over a certain size, or buildings near others that might be considered terrorist targets. In addition, several large insurers and brokers told us that insurers limit the terrorism insurance they provide in these areas to amounts well below their TRIA deductible.

To help insurers determine how much risk, or coverage, they can write in any given location, several industry participants we interviewed said insurers often use computer models to estimate the effect, or severity, of terrorist attacks on their existing book of business. Using models available from risk-modeling firms, insurers can map the locations of properties they cover as well as other types of coverage they provide in the area such as building contents, business interruption, or workers' compensation. Therefore, insurers can consider the extent to which one terrorist attack could trigger losses among multiple lines of insurance. The models also can map the locations of nearby properties considered to be potential terrorist targets. With these mapped locations, an insurer is then able to identify areas where it has the greatest aggregated exposure within a city. The modeling program places a circle around a specific location, such as a

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<sup>18</sup>An insurer's surplus is the difference between its assets and liabilities, or the company's net worth. The surplus is the financial cushion that insurers can draw on in case of unexpectedly high policyholder claims.

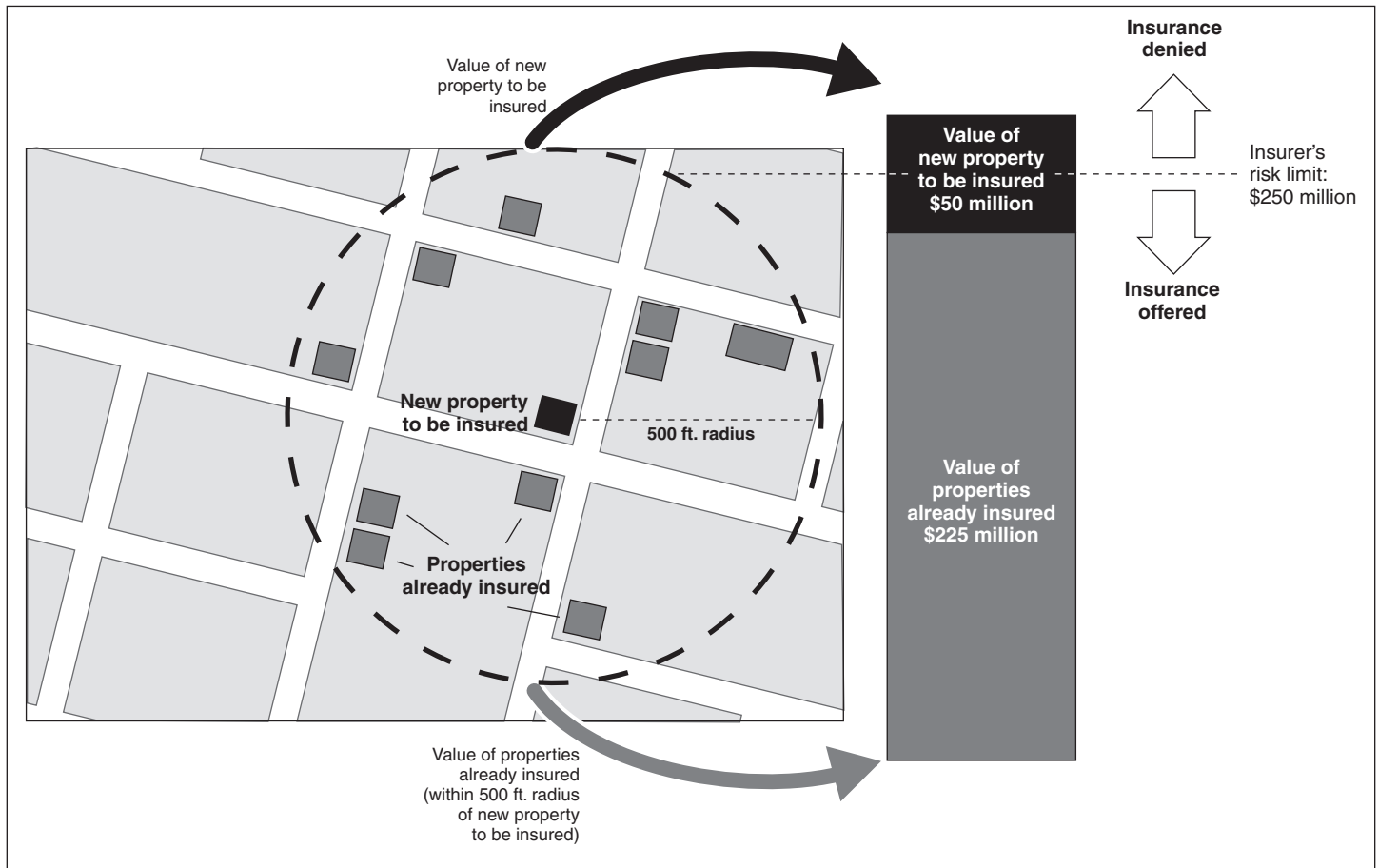
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building in the insurer's book or a potential terrorist target, and aggregates the amount of exposure an insurer has within this defined area. These models take into account the severity of various attack scenarios on properties in the area (for example, a 5- or 10-ton truck bomb) and allow users to quantify potential losses under different attack scenarios.

Insurers we interviewed noted that they are not as comfortable with the estimates of the probability, or frequency, of an attack, from these models and, therefore, make more limited use of this information. While insurers and risk-modeling firms have access to large historical databases and scientific studies of the frequency and severity of natural catastrophes, such as hurricanes, the data on terrorist attacks are limited. Furthermore, according to industry analysts, the tactics, strength, and effectiveness of terrorist groups can be very unpredictable, so predicting the frequency of such attacks is very difficult and perhaps impossible. For example, terrorists might respond to increased security measures in one area by shifting attention to more vulnerable targets in another. Without more information, industry analysts note that it is difficult for modeling firms to make projections about the capability and opportunities of terrorists to undertake future attacks.

While insurers find estimates of the probability of a terrorist attack of limited use, they often use the estimates of the severity of potential attacks in determining the amount of coverage they are willing to provide. Considering potential attack scenarios and estimated losses from the models, insurers impose internal limits, referred to here as aggregation limits, on the amount of all types of coverage they will offer in defined areas. Depending on the amount of capital and risk tolerance of the company, insurers determine the amount of coverage they are willing to provide in defined geographic areas within a city, such as in 250-foot, 500-foot, or quarter-mile circles around certain landmarks or areas where the insurer has high concentrations of risk. Insurers then monitor the amount of coverage that they provide in these areas on an ongoing basis to ensure that they do not exceed their aggregation limits. As shown in figure 3, an insurer might decline to provide any coverage for a new property since adding the property to the book of business would exceed the insurer's aggregation limit on exposures within the defined area. Alternatively, an insurer might charge a higher price or offer a lower coverage limit if adding the property would exceed the aggregation limit.

**Figure 3: Example of an Insurer’s Underwriting Decision Based on Aggregation of Risk in Small, Defined Areas**



Source: GAO.

The amount of coverage insurers are willing to provide in these defined areas may change frequently as new clients or properties are added to or removed from their books of business. An insurer may have available capacity in a specific area one month, but be near its limit the next. For example, one policyholder noted that her real estate investment company contacts its insurer before considering acquiring a new property to determine if the insurer has capacity where the new property is located. Although the insurance company may decide it can provide property insurance for the building at the time of the request, the policyholder said that when the acquisition is completed several months later, the insurance company may no longer have the capacity available to insure the building. In that case, the policyholder said that the company might have to

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purchase a stand-alone terrorism policy for that particular building, which the policyholder reported as being more expensive than simply adding it to the existing portfolio. As a result, the policyholder said it might no longer be profitable for the company to acquire the new building. In some cases, this policyholder said the company has canceled or deferred an acquisition until it simultaneously disposed of a building in the same area to be sure that the insurer would have capacity available for the new building. However, several other policyholders we interviewed said that any concern about the availability of insurance has not affected their companies' acquisitions or development projects.

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### Availability of Reinsurance Also Can Affect Insurers' Willingness to Provide Terrorism Coverage

Insurers and other industry analysts cited the limited availability of reinsurance as another factor influencing insurers' willingness to provide terrorism coverage in certain areas. Reinsurance plays a crucial role in insurance markets by permitting primary insurers to transfer some of the risks that they incur in offering coverage. In so doing, reinsurance may allow primary insurers to offer additional coverage than otherwise would be the case while mitigating potential losses.<sup>19</sup>

Insurers and other industry participants we contacted said that reinsurance for terrorism risk, which largely was unavailable after September 11, continues to be expensive and available in limited amounts. In a 2004 report, we found that reinsurers had reentered the terrorism insurance market cautiously, but that the amount of coverage offered to primary insurers was limited and the premium rates were viewed as high.<sup>20</sup> In conducting our current work, reinsurers and industry analysts said that reinsurance capacity for terrorism has continued to increase for a variety of reasons including an influx of new capital into the industry, the absence of another terrorist attack, and improvements in insurers' ability to underwrite the risk.<sup>21</sup> However, insurance brokers and large insurers with

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<sup>19</sup>For terrorism insurance, primary insurers typically purchase reinsurance up to the difference between what the primary insurers are willing to lose in a terrorist attack and their TRIA deductibles as well as coverage for their 15 percent co-share under the program.

<sup>20</sup>GAO, *Terrorism Insurance: Implementation of the Terrorism Risk Insurance Act of 2002*, GAO-04-307 (Washington, D.C.: Apr. 23, 2004).

<sup>21</sup>According to a trade insurance association representative, the capacity of the global reinsurance market has increased significantly in recent years. The representative said that a wave of \$20 billion in new capital entered Bermuda companies after the September 11 attacks. Similarly, a second wave of \$43 billion in new capital entered the market after Hurricane Katrina.



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significant exposures in urban areas told us that terrorism often still is excluded in reinsurance contracts and that insurers have been able to purchase only limited amounts of very expensive coverage. A recent Congressional Budget Office report similarly found that the ability of primary insurers to transfer terrorism risk to reinsurers is limited.<sup>22</sup>

As has been the case with primary insurers, the efforts of reinsurers to manage their aggregation levels appear to be why the coverage that they offer for terrorism is limited. The provision in TRIA requiring insurers to offer terrorism coverage at terms and conditions that do not differ materially from other coverage does not apply to reinsurance transactions, so these companies have discretion in deciding how much terrorism coverage to offer to primary companies. Reinsurance company representatives told us that the location of the insured risks is an important factor that influences whether they will offer reinsurance and at what price. For example, one reinsurance company representative said that the company was less willing to write contracts covering properties in cities viewed to be at high risk of terrorist attack. Others said that while their companies still would be willing to reinsure an insurer's book of business with concentrations of risk in multiple high-risk cities, they might offer more expensive coverage to compensate for the increased risk and the increased capital they need to maintain to back up the risk.

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### Views of Rating Agencies Also May Influence the Availability of Terrorism Insurance for Some Policyholders in Areas Viewed as at High Risk of Attack

Insurers and reinsurers cited the views of rating agencies on the amount of capital insurers allocate to terrorism risk and the location of risks they insure as other factors influencing their willingness to provide terrorism coverage. Rating agencies assess the financial strength of companies and the credit quality of their obligations. Maintaining a high rating can be very important for an insurance company's business because a firm with a low rating may, among other things, pay a higher interest rate on its debt. In addition, several policyholders and lenders told us many lenders that require their mortgagees to carry terrorism coverage also require that they use only highly rated insurers. A variety of industry participants and analysts told us that rating agencies' views can be very influential on the amount of capacity insurers decide to allocate to terrorism risk, affecting how much coverage they provide to policyholders. For example, one reinsurance industry analyst noted that the amount of capital rating agencies required insurers to maintain to support terrorism risk was

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<sup>22</sup>Congressional Budget Office, *Federal Reinsurance for Terrorism Risks: Issues in Reauthorization* (Washington, D.C., August 2007).

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significant. The representative said that these requirements may encourage insurers not to offer this type of business because it is difficult to maintain large amounts of capital and earn an adequate return on the money.

In conducting their assessments, representatives of the rating agencies we interviewed said they look closely at insurers' terrorism exposures. They request specific information about the types of policies insurers write, the risks in their books of business, the steps insurers take to manage their risks, and whether they have concentrations of risk in any areas, including large urban areas or cities considered to be high risk. With workers'-compensation insurers, the rating agencies request information about the number of employees at different locations across the different insureds. As a result of discussions with the rating agency about the company's rating, rating agency representatives said that some companies have purchased additional reinsurance or divested risk.

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## Various Proposals to Increase the Availability and Affordability of Terrorism Insurance Coverage Have Both Advantages and Disadvantages

Insurance industry participants and analysts did not express consensus on whether TRIA should be modified or additional actions taken to increase the availability of terrorism insurance coverage. They cited a variety of advantages and disadvantages associated with five proposals that have been offered in legislation, discussed in our prior reports, or suggested by industry participants to increase the availability and perhaps limit the cost of terrorism insurance. These proposals include lowering insurers' TRIA deductibles following large terrorist attacks, permitting insurers to establish tax-deductible reserves for future terrorism losses, forming a group of insurance companies to pool assets for terrorism losses, facilitating the issuance of onshore catastrophe bonds through changes in the tax code, and limiting certain state regulations and requirements. We note that improvements in terrorism insurance coverage and pricing that might result from the adoption of some of these proposals (such as tax-deductible reserves, insurance pools, and catastrophe bonds) likely would take place over the longer term and that such proposals could increase the federal government's exposure to terrorist-related losses or otherwise reduce federal revenues.

## Option 1: Lowering Insurers' TRIA Deductibles following Large Terrorist Attacks

One recent legislative proposal to increase the availability of terrorism insurance coverage involved lowering the TRIA deductible for insurers from future terrorist attacks after they experience losses.<sup>23</sup> Under this proposal, if there were a terrorist attack that resulted in more than \$1 billion in damages, the insurer deductible under TRIA immediately would be reduced to 5 percent (from 20 percent) for those insurers suffering losses in the attack.<sup>24</sup> Table 1 below shows the potential effect on the deductibles of five large insurers under this proposal.

**Table 1: Current TRIA Deductibles of Five Large Insurers versus Deductibles under a Recent Legislative Proposal**

Dollars in billions

	Direct written premiums	Current TRIA deductible	Proposed TRIA deductible in case of attack
Insurer A	24.8	4.9	1.2
Insurer B	14.6	2.9	0.732
Insurer C	14.4	2.8	0.721
Insurer D	12.7	2.5	0.635
Insurer E	7.5	1.5	0.375

Source: GAO analysis of Insurance Information Institute data.

Note: The legislative proposal—as outlined in S. 2621, 110th Cong. § 2 (2008) and H.R. 4721, 110th Cong. § 2 (2007)—would reset the TRIA deductible after a large terrorist attack where aggregate industry insured losses exceeded \$1 billion.

Because this proposal was designed to significantly reduce potential industry losses, some insurers and industry participants we contacted said that it might make them more willing to offer coverage in areas affected by a future attack. As a result, supporters of the proposal argue that it would stabilize insurance markets in affected areas and facilitate rebuilding and recovery efforts. Moreover, the representative of one large insurer said that if the deductible was lowered to 5 percent, the insurer immediately would be willing to write more terrorism coverage, especially in downtown areas of larger cities. Since the insurer would be able to access the federal reimbursement at a lower level, the insurer's potential losses

<sup>23</sup>See S. 2621, 110th Cong. § 2 (2008) and H.R. 4721, 110th Cong. § 2 (2007). The proposal would reset the TRIA deductible after a large terrorist attack where aggregate industry insured losses exceed \$1 billion.

<sup>24</sup>The proposal also would increase the deductible by 0.5 percent in each subsequent year with no terrorist attack.

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on its current book of business would be lower, thus freeing up additional capacity for terrorism coverage without having to purchase reinsurance from the private market to cover the additional risk.

While other insurers and industry participants we contacted were not necessarily opposed to this proposal, they remarked that its effects might be limited. As discussed previously, some large insurers already try to limit potential losses associated with a future terrorist attack to levels well below their current TRIA deductible of 20 percent of direct premiums. Therefore, it is not clear what effect lowering the TRIA deductible would have for such insurers in terms of the terrorism coverage that they are willing to offer. Second, as also discussed earlier, there may be significant market disruptions associated with another terrorist attack, which could limit coverage availability even if the federal government did assume greater liability for associated losses. For example, reinsurers, which are not subject to TRIA's requirements to make terrorism coverage available, again might limit the coverage they were willing to provide in the wake of another attack, which might limit the amount of coverage that primary insurers could offer. In addition, as happened following Hurricane Katrina, ratings agencies might increase the capital requirements or other standards insurers must follow to maintain and improve their ratings, potentially further limiting insurers' willingness to continue providing terrorism coverage in certain areas. Further, we note that lowering the TRIA deductible would increase the federal government's potential liability for terrorism-related losses.

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## Option 2: Permitting Insurers to Establish Tax-Deductible Reserves for Future Terrorism Losses

Another option would permit insurers to establish tax-deductible reserves, over a period of years, to cover the potential losses associated with future terrorist attacks. Under current federal tax law, insurers can take a deduction for losses that already have occurred and for setting aside reserves for fair and reasonable estimates of the amount the insurer will be required to pay on future losses. However, reserves for uncertain future losses are not currently tax deductible. Because the size and timing of terrorist attacks are uncertain, any reserves set aside for potential

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terrorism losses would be taxed as corporate income in the year in which they were set aside.<sup>25</sup>

We have reported previously that amending the tax code and permitting insurers to establish tax-deductible reserves could provide insurers with financial incentives to increase their capital and thereby expand their capacity to cover catastrophic risks, such as terrorism.<sup>26</sup> We also reported that supporters of this proposal argued that establishing such reserves would lower the costs associated with providing coverage and encourage insurers to charge lower premiums, which could increase coverage among policyholders. In addition, industry participants we interviewed said if insurers were able to establish tax-deductible reserves, a large terrorist attack could cause less of a strain or shock to industry surplus, or capital, which could help prevent insurer insolvencies in the wake of an attack.

However, several important challenges and tradeoffs may be associated with this option. For example, some industry participants we contacted said it would be difficult for insurers to determine the amount of funds to contribute to such a reserve each year because of the significant challenges associated with estimating the frequency of potential terrorist attacks. Without a reliable method for conducting such estimates, insurers would lack an analytical basis for reserving funds to cover potential losses.

Furthermore, we have reported that overall terrorism insurance capacity might not increase because insurers might use the reserves as a substitute for reinsurance that may have been purchased previously to manage the risks of potential terrorist attacks (reinsurance premiums are already tax-deductible).<sup>27</sup> Because reserving also would convey tax advantages, some insurers might feel that they could limit the expense of purchasing reinsurance. To the extent that insurers reduced their reinsurance coverage in favor of tax-deductible reserves, the industry's overall capacity

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<sup>25</sup> A "property casualty company loss reserve" is an accounting entry, a liability on the balance sheet, for the amount of money the company expects to pay out in the future to cover indemnity payments that will come due on policies already written for losses that already have been incurred and the costs of dealing with the associated claims. Loss reserves do not reflect the pattern of future claims payments. Premium payment funds that cannot be put into loss reserves must be treated as underwriting profits.

<sup>26</sup> GAO, *Catastrophe Risk: U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risks*, [GAO-05-199](#) (Washington, D.C.: Feb. 28, 2005).

<sup>27</sup> [GAO-05-199](#).

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would not necessarily increase. Insurers also might use the reserves to shield a portion of their existing capital (or retained earnings) from the corporate income tax or inappropriately use tax-deductible reserves to manage their financial statements by increasing the reserves during good economic times and decreasing them in bad times. Finally, we note that this proposal likely would reduce federal tax revenues.

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**Option 3: Forming a Group of Insurance Companies to Pool Assets for Terrorism Risks**

Another proposal involves establishing a group of insurance companies to pool their assets, which may allow them to provide a greater amount of terrorism insurance coverage than could be provided by individual companies acting independently of one another. Insurance pools typically are formed to cover large risks, such as hurricanes, which traditional insurance markets do not address readily. For example, a pool could be created at the national level or state level; it could involve mandatory or voluntary participation from insurers; it could be prefunded or postfunded; and if losses exceed the reserves of the pool, the government could provide a financial guarantee or the pool could draw on some other method such as issuing bonds or borrowing funds to make up any shortfall. Table 2 shows that insurance pools have been established in Florida to cover hurricane risks and in the United Kingdom for terrorism risks.

**Table 2: Examples of National and State Reinsurance Programs**

<b>Program</b>	<b>Program description</b>	<b>Coverage</b>	<b>Reinsurance or insurance</b>	<b>Government backstop</b>	<b>Voluntary or mandatory participation</b>
Florida Hurricane Catastrophe Fund (FHCF)	The State of Florida created the FHCF after Hurricane Andrew. FHCF is a state-administered reinsurance program for insurers that offers residential property/casualty insurance in the state. Its purpose is to ensure reinsurance will remain available at relatively stable rates in the aftermath of hurricanes.	Residential property in case of hurricane in Florida	Reinsurance	None. FHCF may issue bonds, collect reimbursement premiums, or impose assessments on Florida insurance companies if funds are insufficient to meet obligations	Mandatory
Pool Reinsurance Company, Limited (Pool Re)	A mutual reinsurer in the United Kingdom that provides pooled industrywide reinsurance of terrorism risks after a specified industry retention level. Pool Re was formed in 1993 following reductions in reinsurance availability after terrorist bombings in London.	Commercial property, business interruption, and consequential losses for acts of terrorism	Reinsurance	Full government guarantee if pool resources are exhausted, after a 10 percent call upon insurers	Voluntary

Source: GAO analysis of information from Coalition to Insure Against Terrorism.

In addition to these programs, one large insurance broker, in consultation with several industry groups, has developed a proposal to form a \$40 billion national reinsurance pool for commercial property terrorism risk.<sup>28</sup> Under this proposal, all insurance policies would cover losses from acts of terrorism and insurers would continue to charge policyholders their own rates for terrorism coverage in accordance with state laws. Insurers would purchase reinsurance coverage from the pool, which would determine its reinsurance premium rate based on analysis of a range of potential losses in urban, suburban, and rural areas. The claim reserves of the pool would be tax-exempt, allowing it to accumulate reserves tax-free from which to pay future losses. In the event of a certified terrorist attack, the insurance industry would pay 5 percent of losses and the pool would pay 95 percent of losses up to \$40 billion. In the event the pool did not have the resources to pay its share of losses, the pool would be funded through the issuance

<sup>28</sup> Aon, *Property Terrorism Update, TRIA in the Balance* (New York, N.Y.: October 2005).

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of bonds.<sup>29</sup> The federal government would be responsible for losses in excess of \$40 billion up to \$100 billion. According to the plan, losses above \$100 billion would be reviewed by Congress.

Some industry participants we contacted expressed general support of an insurer pool to enhance the availability of terrorism insurance coverage. For example, they said a pool could allow insurers to transfer a significant portion of their terrorism-related risk to an outside entity over time, and they could use the accumulated surplus in the pool to provide higher amounts of coverage in the future. Industry participants also noted that a national pool would spread out terrorism risk across a wider base of policyholders of varying risk levels than individual insurers could do alone and would allow insurers to better manage their total accumulations of terrorism risk.

However, several challenges and disadvantages also may be associated with this option. For example, as is the case with tax-deductible reserves, it may be difficult to develop a reliable basis for determining the appropriate size of the pool because of the inherent challenges in estimating the frequency of terrorist attacks. Moreover, other information suggests that insurance pools would not necessarily increase the industry's capacity or ability to offer additional terrorism insurance coverage. According to a study by a global consulting firm on a proposed workers'-compensation pool for terrorism risk and other industry participants, a reinsurance pool might not create new industry capacity or bring in additional capital to support writing more business.<sup>30</sup> The study notes that if the industry as a whole does not have enough capital to manage terrorism risk, then neither can an industry pool that simply combines existing industry capital in a new structure. Furthermore, we note that if premiums paid to the pool were tax deductible as are traditional reinsurance premiums, insurers simply might substitute pool

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<sup>29</sup>The plan specifies that the U.S. government would provide a contingent guarantee to buy bonds issued by the pool if bonds could not be sold in the open market due to a terrorist attack. The bonds would be repaid by assessments levied on all policies from covered lines during the life of the bonds. The bonds would be tax-exempt and have a maturity of up to 30 years.

<sup>30</sup>The Tillinghast and Reinsurance businesses of Towers Perrin, *Workers' Compensation Terrorism Reinsurance Pool Feasibility Study, Summary of Study Findings and Conclusions* (March 2004). The study was facilitated by the American Insurance Association and funded by 14 insurers that account for roughly 40 percent of the workers'-compensation market.



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reinsurance for traditional reinsurance, as might be the case with tax-deductible reserves for individual insurers. Finally, if the pool was a tax-exempt entity, tax-deductible reserves for an insurance pool could reduce federal revenues.

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#### Option 4: Facilitating the Issuance of Onshore Catastrophe Bonds through Revisions to the Federal Tax Code

Another proposal is that the federal government establish certain tax advantages for catastrophe bonds, which supporters argue could facilitate their use for covering terrorist attacks.<sup>31</sup> Catastrophe bonds generally have been issued to cover natural events, such as earthquakes or hurricanes, rather than terrorist attacks and historically have been created in offshore jurisdictions where they are not subject to income or other tax. Under this proposal, tax treatment of catastrophe bonds would be similar to the treatment received by certain issuers of asset-backed securities, which generally are not subject to tax on the income from underlying assets that is passed on to investors.<sup>32</sup> We previously reported that the total costs of issuing catastrophe bonds—including transaction costs such as legal fees—significantly exceed the costs of traditional reinsurance, which may have limited the expansion of the market.<sup>33</sup> Facilitating the creation of onshore transactions by changing the tax code to encourage issuance of catastrophe bonds within the United States could reduce transaction costs.

Some insurance industry participants we contacted said that catastrophe bonds, by tapping into the securities markets, offered the opportunity to

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<sup>31</sup>Catastrophe bonds are risk-based securities that pay relatively high interest rates and provide insurance companies with a form of reinsurance to pay catastrophe losses. A catastrophe bond offering typically is made through an investment entity that may be sponsored by an insurance or reinsurance company. The investment entity issues bonds or debt securities for purchase by investors, thus spreading risk.

<sup>32</sup>Asset-backed securities, for example, are backed by loans or accounts receivable originated by banks, credit card companies, or other providers of credit. Certain issuers of these securities, Real Estate Mortgage Investment Conduits (REMIC), are generally not subject to federal income tax. Instead the income of the REMIC is taxable to the holders of interests in the REMIC. See 26 U.S.C. §§ 860A-860G; GAO, *Catastrophe Insurance Risks: The Role of Risk-Linked Securities and Factors Affecting Their Use*, [GAO-02-941](#) (Washington, D.C.: Sept. 24, 2002).

<sup>33</sup>For additional information about catastrophe bonds and related tax issues, see [GAO-02-941](#); *Catastrophe Insurance Risks: Status of Efforts to Securitize Natural Catastrophe and Terrorism Risk*, [GAO-03-1033](#) (Washington, D.C.: Sept. 24, 2003); *Natural Disasters: Public Policy Options for Changing the Federal Role in Natural Catastrophe Insurance*, [GAO-08-7](#) (Washington, D.C.: Nov. 26, 2007); and [GAO-05-199](#).

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expand the pool of capital available to cover terrorism risk. They also said that amending the tax code to facilitate the bonds' issuance in the United States could be beneficial in achieving that goal. However, many industry participants said, consistent with findings in our previous reports, that the development of catastrophe bonds for terrorism risks involves significant challenges. These challenges may greatly exceed any benefit that would be derived from amending the tax code. As with other options discussed previously, the industry participants said that because of the difficulties associated with estimating the frequency of terrorist attacks, it would be very difficult to structure a catastrophe bond for terrorism that would be acceptable to investors. Data are available on the historical frequency and severity of natural events, such as hurricanes and earthquakes, which helps investors assess the risks that they face in purchasing catastrophe bonds for such risks. Without similar data for terrorist attacks, it is unlikely that a viable market for catastrophe bonds will be established regardless of revisions to the tax code that are designed to help ensure such an outcome. We also have previously reported that the federal government could lose tax revenue under this option and that the proposed changes to the tax code might create pressure from other industries for similar tax treatment.

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### Option 5: Revising Certain State Regulations and Insurance Coverage Requirements

Some industry participants have suggested that states could take certain actions to revise their insurance statutes or regulations to increase insurer capacity for terrorism risk, including amending rate regulation policies and laws on coverage requirements. While, according to information from NAIC, most state insurance regulators do not review rates for large commercial property/casualty insurance contracts, several insurance company representatives said that their ability to charge risk-based prices for terrorism coverage was constrained by insurance statutes and regulations in certain states and the prices these states approved did not reflect the risk to which the insurers were exposed.<sup>34</sup> Additionally, a few industry participants said that terrorism insurance availability may be

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<sup>34</sup>According to information provided by NAIC, the following 10 states and district require prior approval of commercial property rates: California, Hawaii, Iowa, Maryland, Michigan, New Mexico, New York, North Carolina, North Dakota, South Carolina, and Washington, D.C. While the State of Michigan has a prior approval law, an NAIC representative said that the Commissioner has exempted insurers from filing rates and forms for commercial lines insurance products. Some states, like New York, also have exceptions for large commercial risks, which are discussed in this report.

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limited in states that have adopted the Standard Fire Policy (SFP).<sup>35</sup> Under the SFP, property insurers are required to cover losses from fire regardless of the cause of the fire, including a terrorist attack, even if the policyholder declined terrorism coverage. Consequently, the industry participants said that the SFP influences the amount of property insurance that insurers provide, including terrorism insurance, and the premiums that they charge in states that have adopted it. Therefore, some insurers have suggested that states amend their SFP statutes so that insurers would not be responsible for fire losses resulting from terrorism.

While most states do not regulate prices for commercial property risks, where prices are regulated the state regulators are unlikely to disapprove insurers' rate requests because insurers are in a better position to judge the necessity of the price than the regulator, as long as the request is generally in line with current market prices, according to a representative from NAIC. In addition, other available information suggests that state actions on rate regulation or coverage requirements may have a limited effect on the availability of terrorism insurance coverage. As discussed in this report, some policyholders, particularly in Manhattan, may face initial challenges in obtaining terrorism coverage at prices viewed as reasonable. However, according to state regulatory officials, New York is one of the states that generally does not regulate premium rates for large commercial properties, so state regulation does not appear to be a significant factor in the city where insurance challenges appear to be most pronounced.<sup>36</sup> On the other hand, unlike several other states, New York and California have not revised the SFP to limit insurer liability resulting from the fires associated with terrorist attacks, according to information from industry

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<sup>35</sup> According to information from the Insurance Information Institute and the Insurance Services Office (ISO), states that do not allow exclusions to the SFP for terrorism, thereby requiring coverage for fire following an act of terrorism, are California, Georgia, Hawaii, Iowa, Illinois, Maine, Massachusetts, Missouri, North Carolina, New Jersey, New York, Oregon, Rhode Island, Washington, West Virginia, and Wisconsin. The Virgin Islands also do not allow SFP exclusions for terrorism. Some of these states exempt the SFP requirements for the commercial inland marine line of business. Connecticut and Virginia enable an exclusion of fire following a certified act of terrorism. Fire coverage in both of these states would be required if TRIA expired.

<sup>36</sup> New York Insurance Department officials told us that large commercial property policies (above \$100,000 in premium) as well as certain types of other risks can operate in what is called a "Free Trade Zone" in the state, where insurers have more discretion on determining the prices and terms of coverage they offer as long as they adhere to New York's statute that they are "neither excessive, inadequate, nor unfairly discriminatory." According to information from NAIC, several other states also have similar provisions exempting large commercial risks from rate regulation.

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analysts. While the SFP may therefore have an influence on the availability of terrorism insurance in such locations as Manhattan and San Francisco, it is difficult if not impossible to determine the influence as compared to other factors in these cities, particularly the potential losses associated with attacks on high-value buildings that may be in proximity to one another.

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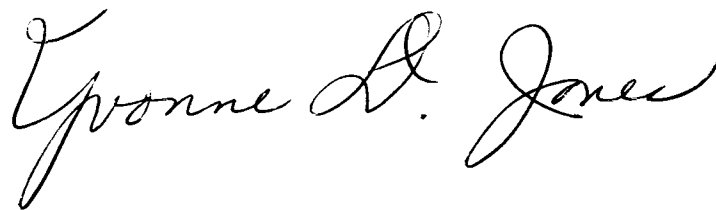
## Agency Comments

We provided a draft of this report to Department of the Treasury and NAIC for their review and comment. In oral comments, Treasury and NAIC officials said that the report was informative and useful. They also provided technical comments that were incorporated where appropriate.

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We are sending copies of this report to the Department of the Treasury, NAIC, and other interested committees and parties. We will also make copies available to others upon request. In addition, the report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staffs have any questions about this report, please contact me at (202) 512-8678 or [jonesy@gao.gov](mailto:jonesy@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix II.



Yvonne D. Jones  
Director, Financial Markets and Community Investment

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# Appendix I: Objectives, Scope, and Methodology

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Our objectives were to describe (1) whether the availability of terrorism insurance for commercial properties is constrained in any geographic markets and the effect of any constraints on pricing and coverage amounts, (2) factors limiting insurers' willingness to provide coverage, and (3) advantages and disadvantages of some public policy options to increase the availability of property terrorism insurance.

To assess whether the availability of terrorism insurance for commercial properties is constrained in any geographic markets and the effect of any constraints on pricing and coverage amounts, we reviewed relevant literature and compiled and analyzed available data on insurance and reinsurance industry capacity, terrorism insurance take-up rates, and terrorism insurance pricing. We also interviewed representatives of more than 100 organizations with knowledge of the nationwide terrorism insurance market and with expertise in specific geographic markets. Entities with a national perspective included insurer and policyholder trade associations, individual policyholders, national insurance and reinsurance brokers, and insurance and reinsurance companies. We obtained information on specific geographic markets from state regulators, regional insurance brokers and insurance companies, and local property owners. The geographic markets we studied represent locations considered to be at high, moderate, and low risk of exposure to terrorist attacks—Atlanta, Boston, Chicago, New York, San Francisco, and Washington, D.C. We selected these markets based on rankings of locations by risk of terrorism exposure that accounts for the risk of terrorist attacks and the potential for associated losses from the Insurance Services Office, an insurance industry analytics firm. We spoke with representatives of policyholders that own hundreds of properties nationwide, including

- more than 200 properties in New York City,
- more than 100 properties in Washington, D.C.,
- at least 30 properties each in Chicago and San Francisco,
- about 30 properties in Boston and 60 in Atlanta, and
- numerous properties across the United States including major cities such as Los Angeles and Houston.

These properties included large office towers in major U.S. cities, properties in proximity to high-profile federal buildings, hotels, industrial

buildings, hospitals, sports stadiums, and residential properties in locations throughout the United States. The policyholders also represented a variety of industries that included real estate, transportation, financial services, health, hospitality, and entertainment. In addition to one-on-one interviews, we also conducted group discussions with representatives of 14 policyholders at the annual Risk and Insurance Management Society conference in San Diego, California, in April 2008. Although we selected industry participants to provide broad representation of market conditions geographically and by industry, their responses may not necessarily be representative of the universe of insurers, insurance brokers, policyholders, and regulators. As a result, we could not generalize the results of our analysis to the entire national market for commercial property terrorism insurance. We determined that the selection of these sites and participants was appropriate for our objectives and that this selection would allow coverage of geographic areas, key markets, major insurers and policyholders, and other organizations related to terrorism insurance so as to generate valid and reliable evidence to support our work.

To identify the factors limiting insurers' willingness to provide terrorism insurance coverage, we selected large, national insurance companies to interview based on their market share in the states we studied. These national insurance companies held from 37 to 52 percent of the market share in the states we studied, according to information provided by the Insurance Information Institute. In addition, we interviewed representatives of regional insurance companies in our selected markets. We also spoke to representatives of seven reinsurance companies, including two of the largest worldwide reinsurance companies, risk modeling firms, state regulators, and two credit rating agencies. Although we selected insurers to provide broad representation of size and geographic scope, we could not generalize the results of our analysis to the entire population of commercial property insurers.

To explore the advantages and disadvantages of some public policy options to increase the availability of property terrorism insurance, we relied on our interviews with the industry participants described above. We also interviewed academics who have written on the topic of terrorism insurance, and representatives of research organizations and consumer interest groups. We selected the option that would reduce insurers' TRIA deductibles in areas affected by a future large terrorist attack from two recent legislative proposals. We selected the other options—allowing insurers to establish tax-deductible reserves, forming a group of insurance companies to pool assets, and facilitating the use of catastrophe bonds

through changes in the tax code and amending state regulations or statutes—from literature we reviewed, our prior reports, and interviews we conducted with industry participants. The selected options were representative of the range of possible options. We did not attempt to evaluate the prospective effect of these options and, therefore, did not come to any conclusions about the advisability of implementing these options.

We conducted this audit in Atlanta, Georgia; Boston, Massachusetts; Chicago, Illinois; New York, New York; San Diego, California; San Francisco, California; and Washington, D.C., from January 2008 to September 2008, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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# Appendix II: GAO Contact and Staff Acknowledgments

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## GAO Contact

Yvonne D. Jones, (202) 512-8678 or [jonesy@gao.gov](mailto:jonesy@gao.gov)

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## Staff Acknowledgments

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