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CONGRESSIONAL TESTIMONY

TRIA: Time to End the Program

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Committee on Financial Services,
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Chairman Biggert and Ranking Member Gutierrez, thank you for inviting me to participate in this hearing. I am David C. John, the Senior Research Fellow in Retirement Security and Financial Institutions at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The Terrorism Risk Insurance Act (TRIA) served a very real purpose in the days after 9/11 when insurance companies and their customers feared the cost of providing coverage for acts of terrorism would be prohibitive. However, we have now reached a point where the private sector is increasingly capable of providing that coverage at appropriate prices without government support. In fact, the continued existence of TRIA may keep the industry from further progress. However, the industry will need time to make the transition to a fully private terrorism system, and it is greatly to the Subcommittee's credit that you are beginning to discuss this issue now instead of waiting until closer to the program's 2014 expiration date.

Back in 2001, TRIA served a real purpose. Without swift but well-considered action from Congress, thousands of American businesses might have been unable to continue purchasing affordable terrorism insurance. The massive losses from the September 11, 2001 attacks made property and casualty insurers understandably reluctant to continue to issue property insurance policies that included terrorism coverage until they could evaluate their exposure to potential terrorist attacks. They were equally reluctant to issue stand-alone policies that only covered acts of terrorism.

Before TRIA, property and casualty insurers faced a serious dilemma. Many of their corporate policies issued before the 9/11 attacks insured against terrorist attacks in much the same way they covered natural disasters or more conventional accidents. Then and now, insurance premiums on most types of loss were based on sophisticated estimates of the likelihood that a particular claim will have to be paid. Until September 11, insurers never expected the scale of damage inflicted in those attacks. Thus before 9/11, terrorism coverage often carried a very low price tag and often was included without much additional though in more comprehensive coverage.

Then the world changed. Insurers and the rest of us discovered that such attacks were possible and could cause catastrophic damage. At the time, none of us had any firm idea whether those attacks were isolated incidents or not. As a result, they were unable to price terrorism coverage quickly and accurately, and unwilling to expose their companies to claims that could run in the tens of billions of dollars.

Losses from the World Trade Center attacks were spread among many foreign and domestic insurers and "reinsurers." This is standard practice for large policies; insurers essentially spread the risk among many other companies in return for a share of the premiums generated by the policies. Some of the risk is sold to reinsurers, who generally insure the insurance companies against huge losses. In this way, no one company is left facing ruin when there is a huge claim on a policy. This method enabled the industry to absorb the roughly $35 billion in claims from the attacks on the World Trade Center. However, in the days after 9/11, many insurers and reinsurers that would have had great difficulty paying another such loss were unwilling to renew policies that include terrorism coverage.

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

While the problem in 2001 was real, it should have been temporary. By now, normal insurance industry processes should have already been able to resolve it. The industry should have developed ways to price terrorism coverage properly, which could include upper limits on company liability. And reinsurers should have found ways to involve sophisticated investors who, for a price, could face the type of losses that could occur.

Recent industry data indicates that there has been a great deal of progress towards making terrorism coverage both widely available and affordable. While coverage varies according to geographic area and industry, some industries show that over three-quarters of larger firms have purchased some form of terrorism coverage. In addition, the cost appears to be declining, with one major report suggesting that the cost dropped by almost a third between 2008 and 2009 alone. Clearly, the process is well underway, and Congress should remove the last barriers to restoring full private coverage for acts of terrorism by ending TRIA.

The recession has had a negative effect on the number of firms that have been able to renew their coverage, but this is to be expected. Faced with cash flow problems, firms will cut wherever that can. What is concerning is that industry sources suggest that the risk models used for terrorism insurance are still more primitive than those used for other types of catastrophic coverage. This may well be due to the continued presence of TRIA, which limits a firms risk exposure and may cause them to focus more on the risk that the firm retains than on the potential losses that the government would cover.

TRIA was not intended to be a permanent program. As the original bill stated, TRIA would "provide temporary financial compensation to insured parties, contributing to the stabilization of the United States economy in a time of national crisis, while the financial services industry develops the systems, mechanisms, products, and programs necessary to create a viable financial services market for private terrorism risk insurance." Returning this coverage to the private sector is an important goal, because there is no reason why taxpayers should continue to have the ultimate financial responsibility for paying insurance losses on private property. The insurance crisis has passed, and the insurance industry now has enough information about terrorist attacks to again provide this coverage. As a result, there is no reason to extend TRIA beyond its scheduled 2014 expiration date.

Some insurance industry associations and others argue that without TRIA, terrorism coverage will revert to some level of problems, but this should not be the case. By 2014, the industry should have over 12 years of data that would allow it to appropriately price its coverage. If, and let me stress the *if*, the industry cannot assume total responsibility, Congress should start the process in early 2013 by implementing proposals such as increasing the deductible to be paid by insurers, increasing the insurer co-participation, increasing the event trigger, removing coverage for acts of domestic terrorism; and reducing the recoupment percentage from 133 percent to 100 percent. These changes should take effect almost as soon as they can be passed

That should be followed by a full phase-out of TRIA so that the entire program has ended no more than two years after the current 2014 expiration date. *If* these steps are necessary, Congress should also strongly indicate to the industry that further extensions will not come, and that it should expect to offer terrorism coverage after that without any further taxpayer subsidies.

Let It Expire

Congress should neither extend nor expand TRIA without a firm and short phase-out, and if Congress passes any longer extension, whoever is in the White House after January 20 should reject such legislation. Continuing to pass the risk of property insurance losses caused by terrorist attacks to taxpayers does nothing to increase security. Rather, programs like TRIA encourage insurance companies to avoid the proper pricing of coverage, with the expectation that federal reinsurance under TRIA will enable them to pass on significant losses to taxpayers. TRIA is thus a pre-approved bailout for insurance companies, the essence of corporate welfare. There was a good reason to establish TRIA, but those days are over. TRIA has served its purpose and should now be allowed to expire.

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