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Viewpoint: The Case for Government-Backed Terrorism Insurance

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This article was adapted from the testimony of Erwann Michel-Kerjan, managing director of Wharton's Risk Management and Decision Processes Center, before the U.S. Congress, House Subcommittee on Insurance, Housing and Community Opportunity's Committee on Financial Services in 2012.

Given the series of unprecedented disasters and crises that has occurred since 2001, finding solutions to better manage and finance catastrophes are high on the agenda of top decision-makers around the world.

In the United States, recent extreme events – natural, environmental, technological, corporate, and financial – have cost not billions but trillions of dollars. That's more than in any other country – which should be a sobering record. America has proven to be a resilient nation. But if these events are predictive of what the near future will look like, we as a country have to start a serious discussion about our ability to better prepare for and recover from future catastrophes, physically and financially.

On the terrorism front, which the recent tragedy in Boston shows is always with us, the debate about the Terrorism Risk Insurance Act (TRIA) is intense.

On June 17, the New York City Council Committee on State and Federal Legislation held a hearing to discuss proposed NYC Council resolution 1806-2013, which calls on the federal government to enact a long-term extension of the Terrorism Risk Insurance Act (TRIA). But so far, there is no national consensus that this program should be extended.

TRIA was passed by President Bush in 2002 when insurers in many states decided to stop covering businesses against terrorism after suffering what was back then the most costly disaster in the history of insurance. After 9/11, reinsurers (which paid most of the losses) left this market, and that left insurers unprotected. TRIA forces insurers to offer terrorism risk insurance to all their clients, and to benefit from free up-front reinsurance from the federal government above an industry threshold of $25 billion and up to $100 billion. Extended in 2007 for 7 years, the program is supposed to expire in 18 months.

At the center of the debate against TRIA is the thought that, if the federal government continues its pattern of renewing TRIA, it will continue to distort the insurance market by displacing long-term private market activity that would have otherwise emerged. It is, of course, impossible to verify this logic unless one lets TRIA expire and observes what happens over time, which could be a risky proposition.

I typically favor market-based solutions over any federal intervention. But my experience with terrorism risk and terrorism risk financial protection in many developed countries tells me that the real challenge of no TRIA-like protection post 2014 does not lie so much on the immediate disruption this could have on several industry sectors. Rather, the challenges will be the longer-term economic consequences of a future attack on U.S. soil and the question of who would ultimately pay for the recovery.

A paradox that has been somewhat overlooked in discussions about terrorism insurance in the U.S. is that a world without TRIA does not necessarily mean less financial exposure of the federal government to the economic consequences of terrorism. It might very well mean, de facto, increased financial liability for all of us as American taxpayers.

If TRIA were to expire, and unless reinsurers re-entered the U.S. market with much more capacity than they provide today (which is unlikely given their choice to severely limit their exposure to terrorism risk in Europe and in the U.S.), most primary carriers are likely to exclude this risk from their portfolio everywhere they can.

Those that do not exclude it will charge much higher premiums than they currently do to take into account expensive capital they need to set aside to meet regulatory and/or rating agency requirements. This is not necessarily a bad thing – it means market-based prices. And if there are no future attacks, that looks good – as would any mechanism absent of claims. But the day after a large attack, we would realize that many firms are uninsured or poorly insured.

One might argue from a conceptual view that these firms should be diversified enough, especially if they are publically traded. But there is the political reality: Under extreme pressure from media and interest groups, the federal government will be asked to step back in. And as recent experience from corporate bailouts and disaster relief shows, it absolutely will.

Is that really the best we can do to prepare our nation? I don't think so.

TRIA is not perfect, of course. It provides federal reinsurance at no up-front cost to insurers, who keep 100% of the premiums they collect. That is unique worldwide. In one of the 20 studies on terrorism insurance our team at the Wharton Risk Center has published so far, we showed that this free up-front reinsurance had led to much more capacity being deployed in the market – a good thing for businesses, but also with a higher concentration of exposure in insurers' portfolios than they would have assumed otherwise.

One option would be for the Federal Reserve to start charging insurers to compensate for its de facto financial liability under TRIA. Judging by my recent conversations with engaged parties, this might actually become a condition for TRIA to be extended, along with increasing the level of losses insurers will have to pay for before receiving any reinsurance funding from the government.