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## **Symposium Remarks: Terrorism and its Impact on Insurance: Legislative Responses and Coverage Issues**

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# SYMPOSIUM REMARKS: TERRORISM AND ITS IMPACT ON INSURANCE: LEGISLATIVE RESPONSES AND COVERAGE ISSUES

GAIL P. NORSTROM\*

Everything I'm going to talk about will be geared toward large property commercial property insurance placements. If you would, the Fortune 1000 type placements. Where we digress from that client base we will so note.

There is a lot of grit in the wheels of the economy due to the issues related to the business dynamics of the late nineties. Then superimpose upon this the risk of terrorism. Everyone you talk to at Treasury says the whole purpose of TRIA<sup>1</sup> was to help oil those wheels of commerce and provide some economic incentive to create an insurance market for terrorism. These kinds of issues, the volatility and the uncertainty associated with terrorism, is a very different kind of economic risk to this country than we have had in the past.

What's going on? There has been an immense amount of energy spent by insurers and brokers on their clients' behalf to try to understand what's going on with TRIA. Not many clients are buying. As far as the in-force policy offer that was mandated

\* These remarks are an actual transcript of the author's comments at the St. John's Journal of Legal Commentary Symposium on Mar. 14, 2003.

<sup>1</sup> Terrorism Risk Insurance Act of 2002, 107 Pub. L. 297, 116 Stat. 2322 (2002). Section 101(b) of TRIA states its purposes as:

The purpose of this title is to establish a temporary Federal program that provides for a transparent system of shared public and private compensation for insured losses resulting from acts of terrorism, in order to - -

- (1) protect consumers by addressing market disruptions and ensure the continued widespread availability and affordability of property and casualty insurance for terrorism risk; and
- (2) allow for a transitional period for the private markets to stabilize, resume pricing of such insurance, and build capacity to absorb any future losses, while preserving State insurance regulation and consumer protections.

*Id.* at § 101(b)(1)-(2).

during the 90-day period commencing November 26th,<sup>2</sup> we are seeing that our clients who rely on risk management strategies other than the purchase of insurance, are thinking more thoughtfully about TRIA in the context of their next renewal.

Why are some policyholders buying TRIA? Principally inner-city risks in the major metropolitan areas,<sup>3</sup> or those that have some idea that they're exposed based on their security department's analysis are buying TRIA.<sup>4</sup> Also buying, are insureds who believe they are targets (like entertainment venues) or responsible for major infrastructure facilities.<sup>5</sup> Finally, there is a body of buyers out there who adopted a "buy" strategy because it (TRIA) was relatively cheap. From a property insurance premium point of view if it's less than five percent of the premium, why not buy? These buyers thought process goes like this; "I had a terrorism exclusion before and now for five percent of my premium and I can make that exclusion go away, why not?"

Who's buying? Real estate and construction firms top the list as to who has purchased the TRIA coverage.<sup>6</sup> This is mainly due to mortgage or other contractual obligations. Marine facilities and other types of target businesses have also been some of the early adopters. But, why in general are policyholders not buying? I think the key thing, particularly in the manufacturing section; America is in denial. They do not feel they are exposed. There has been a discussion in the boardroom of just about every Fortune 1000 company where the Corporate Security Chief has

<sup>2</sup> *Id.* § 103(b)(2)-(b)(3) (stating that no payment will be made by the Secretary of the Treasury for loss under the act unless the insurer provides clear disclosure to the policyholder of all terms of the act within 90 days of November 26, 2002, the date the act was passed).

<sup>3</sup> See *U.S. Terrorism Insurance Too Costly For Many*, FORBES, available at <http://www.forbes.com/newswire/2003/04/17/rtr943880.html> (Apr. 17, 2003) (discussing the prohibitively high prices attached to terrorism insurance for "highly visible" metropolitan would-be insureds, such as stadiums, apartment buildings, and major financial centers).

<sup>4</sup> See generally Susan Reda, *Terrorism Insurance - What's Your Level of Risk?*, STORES MAG., available at <http://www.stores.org/archives/2003/05/cover.asp> (May 2003) (discussing recent risk assessments being weighed against the high cost of terrorism insurance by businesses in metropolitan areas).

<sup>5</sup> *Id.* (noting that some owners of strip malls across the country are being pro-active and purchasing terrorism insurance).

<sup>6</sup> See Dave Lenckus & Roberto Ceniceros, *High Rates for Terror Cover Shift Focus to Preparedness*; *RIMS 2003*, BUS. INS., Apr. 21, 2003, at 10 (citing example of successful Milwaukee-based real estate firm who purchased coverage under TRIA and their rationale behind it).

gotten up and said, "we've got it covered, we're cool." However, you can never be prepared enough for the ingenuity of the devices, nor for the motivations of the people that are our enemy.

Another issue is the measurement of terrorism risk. There is a lot of talk about the lack of risk models that we can believe to be credible. I was in the insurance business in the early days of earthquake and windstorm models and was probably one of the early doubters. But, as you become more familiar with how these models work they become very useful tools. They do not tell you how to make a decision, but they certainly frame the construct of your decisions. I think insurers need terrorism models to support their underwriting. For that matter, the more sophisticated risk management retail buyer, the more the company risk manager would like to be able to have access to these kind of models at some point.

Back to TRIA. The rollout process was quite chaotic. The layering, and quota sharing of how various insurance programs are put together greatly complicated the picture. For example, you could get the price of a dollar in the first layer and two dollars for the next excess or the second layer. It is just all over the map. Many risk managers are saying "I am just going to wait until renewal and maybe we can make a little more sense out of it then." Besides that, they say "I can go upstairs in the meantime, see my boss and maybe create a budget for this."

To reiterate, pricing was all over the map. It was expensive in many cases.<sup>7</sup> By expensive, I am defining that as higher than the median or the average. Some of the risk we have talked about as being more exposed probably deserved higher pricing. It was very clear that some carriers did not want this risk on their balance sheet and they wanted to price themselves out of it. We had little cookie factories up in the northern woods of Minnesota where the price was one hundred percent of the property premium. Meanwhile, for a nice 20-story building on the Upper West Side of New York it may be a 15% surcharge on the property premium. So pricing was just all over the lot. Because TRIA is new as is the whole idea of thinking about your

<sup>7</sup> See Richard Allyn & Heather McNeff, *Justice in a Changed World: The Fall and Rise of Terrorism Insurance Coverage Since September 11, 2001*, 29 WM. MITCHELL L. REV. 821, 842 (2003) (discussing how many insurers claim deductibles too expensive, creating huge liability before federal dollars even become available).

insurance policy in the context of either having or not having a terrorism exclusion and, further, even to the finer points of that exclusion applying to certified events or non-certified events . . . this is a new risk management decision. Thus, if you are the risk manager of a firm and you have a budget and a process to buy property in casualty insurance, now you have to add your terrorism purchase decision. This is something that frankly, in many cases is getting sign-off at the Board of Directors' level. So it's something that you have to prepare for very carefully, and think out very thoughtfully. It is also something that we are in the early stages of truly understanding and appreciating.

There are other things that we have to think about — certified and non-certified events,<sup>8</sup> fronting,<sup>9</sup> captives,<sup>10</sup> and nuclear, biological and chemical (NBC) events.<sup>11</sup>

First, certified versus non-certified events. TRIA was geared toward acts perpetrated by foreign terrorists, but there are also special interest groups who will commit the same acts. I am involved with one of our public entity insurance broking groups. We are doing a placement for a public entity out in the western part of the United States. They have no interest in TRIA, but they are very interested in domestic terrorism. They are in the crosshairs of some "Montana Mountain Men" type organization, not foreign terrorists. Around the country there are different oxes to be gored, depending upon your industry, what you do, and who you are. The problem is that all these groups use the same techniques like truck bombs, anti-personnel weapons, or the famous shoe bomb.<sup>12</sup> So when an event occurs how is Treasury going to engage in the certification process? The interim final rule that came out a couple weeks ago that dealt pretty well, I

<sup>8</sup> See Marta Hummel, *Real Estate Industry Lobbies for Renewed Terror Insurance Subsidiaries*, N.Y. SUN, Jan. 8, 2004, at 5 (distinguishing foreign terrorist events as government-certified events and domestic terrorist events as non-certified).

<sup>9</sup> See *Risk Management; Mind the Gaps*, REINS. MAG., May 1, 2003, at 22 (noting how fronting companies have limited coverage to global companies due to TRIA).

<sup>10</sup> See Meg Fletcher, *Risk Managers Mindful of Terrorism Coverage Options*, BUS. INS., Oct. 20, 2003, at 4 (observing how captives have played major role since implementation of TRIA).

<sup>11</sup> See Tom Clonan, *Expert Advice Needed to Combat Threat*, IRISH TIMES, Oct. 10, 2001, at 10 (pointing out that the best defense against an attack is the NBC suit).

<sup>12</sup> See generally Peter G. Chronis, *Legacies of War: Land Mine Problem Explosions Maim, Kill 500 per Week*, DEN. POST, Sept. 15, 1996, at B-02 (stating that modern anti-personnel land mines are now encased in plastic instead of metal, making them much more difficult to detect and more tamper proof).

thought, with the definition of insurers.<sup>13</sup> But, the certification process is still unclear; we have been promised that there will be some pretty detailed discussion of that later on. This is where the devil is in the details, because what is Treasury going to do if there is a terrorist act involving one of these sleeper cells we keep hearing about where it's American citizens who are involved. My feeling is there will be a bias to err on the side of certification, but until we actually see the regulations we will not really have a good sense of that.

The second major issue is fronting. One of the things that we as insurance brokers like to do is have programs be fronted by a single carrier. When we can do this the client enjoys a single policy issuer and service provider, that type of thing. Fronting arrangements were becoming more difficult to arrange in 2001, and after 9/11, fronting was virtually impossible to arrange because carriers did not want to be responsible to collect the reinsurance recoverable from other carriers. Typically these "reinsurers" in these upper layers would be other primary insurers. These programs would be put together by Marsh and AON and other brokers to operate as a unified placement for administrative simplicity. Now in the aftermath of TRIA, that fronting carrier has all the responsibility, all the obligations — notice, coverage and everything else under TRIA — because the business of reinsurance is exempted from TRIA.<sup>14</sup> Thus if you are an insurance carrier and you act as a reinsurer behind AIG or any other insurance carrier, you have no TRIA coverage. To make it even a little bit more complicated, let's just say the insurer fronts for the all risk property program and your offer of TRIA is declined. If the client declines TRIA to fronting carrier, the reinsurers will want to exclude "fire following" from their all risk property (re)insurance behind this fronting carrier because they have no access to TRIA. Thus, in this case the policyholder would lose not only coverage for the direct damage due to an act of terrorism but also coverage for fire, which could result from the act. TRIA has made the mechanics of putting together a

<sup>13</sup> See Diane Levick, *Insurers: Remove Terrorism Loophole*, HARTFORD COURANT, Mar. 6, 2003, at E1 (demonstrating the difficulty in defining the term "terrorism" for insurance purposes).

<sup>14</sup> See Ellen Kelleher, *Report Indicates TRIA is Failing to Meet Targets* News Digest, LONDON TIMES, June 2, 2003, at 17 (explaining that the lone underwriting tool of insurers is to quote high prices to discourage take-up in cities where terrorism risks are high).

fronted large global program for a multinational company, or a very large individual risk requiring a lot of limit here in the U.S., a very difficult thing.

Thirdly, a little discussion of captives is in order. The interim final rule that came out two weeks ago made pretty clear that if a captive is licensed or admitted in any state and they receive direct turn premium, they are subject to TRIA.<sup>15</sup> There has been a lot of interest lately with forming new domestic captives to help deal with some of these fronting and administrative issues that were discussed earlier.

Non-U.S. domiciled captives are not subject to TRIA.<sup>16</sup> The latest federal regulation said they are still looking at it.<sup>17</sup> Clearly, offshore captives in places like Bermuda have become very important risk management tools. I think they (Treasury) would like to find a way to handle these, but I am not sure what that (solution) might be at the moment. U.S. domiciled captives are not subject to TRIA if they act as a reinsurer behind an admitted carrier, or if they are involved with some of the other lines of insurance excepted from the bill.<sup>18</sup>

Finally, Nuclear, biological, chemical exposures are a huge issue in my mind. This is a gaping hole, not so much in TRIA, but rather in the interaction of TRIA and the reality of these kind of losses, and the stress on insurance companies' balance sheets that these events could create. You can see the kinds of devices here that people can roll in your front door, or send you through the mail. They are light, portable and they have the potential of causing immense losses. I do not know what the answer is. However, if you look at the various insurance policy endorsements making their way through the state approval process, not so much New York, but in states that are pretty strong followers of the ISO endorsements,<sup>19</sup> we are seeing actual

<sup>15</sup> See generally Jill Cueni-Cohen, *Districts Insure Against Terrorism*, PITTS. POST GAZETTE, Jan. 29, 2003, at N-2 (discussing the process of presidential declaration and district certification of a terrorist event).

<sup>16</sup> See generally Simon Cooper, *U.S. Terror Law: Insurers Bear The Brunt*, INS. DAY, Feb. 12, 2003 (stating that the original formulation of TRIA did not address captives).

<sup>17</sup> See *id.* (noting that the U.S. Treasury later announced their impending inclusion but has not yet issued guidelines).

<sup>18</sup> See *id.* (clarifying that reinsurers are not subject to TRIA but are also excluded from any compensatory benefits under the act).

<sup>19</sup> See generally Charles H. Cox, *The Evolution of Terrorism Exclusions*, 4 RISK & INS. 13, 14 (2002) (detailing extensive state support for ISO exclusions for biochemical

exclusions for acts of biological and chemical terrorism. It is called "Other Acts of Terrorism." These endorsements are working their way through the approval process now.

Clearly, the industry is moving toward absolute exclusion of these kinds of events, and they are handling this as an issue for state regulation. If compromises could be worked out there could be coverage for nuclear, biological or chemical events to some degree, allowed in the states, as these losses would roll up into the TRIA mechanism. But that is a very difficult economic equation to achieve in today's world.

As mentioned earlier, these endorsements are going through the approval process right now. If you have not heretofore had an exclusion, you will soon receive notification, that there is this absolute cap on coverage for certified events. This is a global, national, worldwide view of insurance at the carrier level. How TRIA works at that nexus with state regulation creates the reality of coverage for the policyholder. This gives you a sense of just a few of the form issues that are evolving from TRIA.

The way I think most people would like to approach deciding what to do about terrorism would be summed up in some sort of a flow chart. All we have really been talking about is, do I buy TRIA or not? But as we advise our clients, we ask them to take a high-level view. Just how exposed do you feel you are? (There are techniques that you can use to determine that.) How does this risk affect my non-U.S. exposures? How does it affect my U.S. exposures? In the case of the U.S. exposures, how does TRIA work with the equation?

Pricing is another issue. As stated earlier, carriers are adopting highly differentiated pricing strategies. It's all over the lot. Those that are not subject to TRIA, like some of the alien markets in Bermuda, are pricing TRIA as though it is free-standing sabotage and terrorism, which is quite a lot less expensive than it was a year ago, but still very costly. Some are being intentionally non-competitive. Other carriers are just saying I will waive a premium charge now and deal with it later in the year. Pricing ranges from two percent to three hundred percent of property insurance premium. We are seeing a median

terrorism).

of about twelve percent nationally across all property now, across all types of business, manufacturing and the like . . . eighteen percent in the top tier urban areas.<sup>20</sup> We are seeing twenty-five to fifty percent surcharges on New York real estate, and about eleven percent surcharge to real estate in non-target areas.

Comparing the limits that are available in today's property insurance programs and the deductibles the passage of TRIA has clearly created improvement. Because TRIA has to be offered to policyholders at substantially the same terms, the amount of limit and the lower deductible that's available by purchasing the main property insurance (at least for the foreign terrorism component) is making the end product is more attractive. We are looking across our entire book of business and estimate TRIA as being about twenty percent of the price of what freestanding sabotage and terrorism was toward the end of last year. It is maybe not quite as harsh a comparison now, because the terrorism market, particularly the London market, is also subject to TRIA recovery. So TRIA has a beneficial effect in the freestanding sabotage and terrorism market as well.

Freestanding sabotage and terrorism remains viable in some situations. For instance, if you have a fronting issue you may choose to have a U.S. domiciled captive front for the whole program, cede the all risk property to other insurance carriers, and keep the TRIA exposure. Then the captive can reinsure the risk to the sabotage and terrorism markets. We are seeing a few of those situations.

For the multinational corporations there is the international component that has to be dealt with, as TRIA does not apply. There are also layered and quota share situations where we have carriers that are subject to TRIA and not subject to TRIA, or other situations where the carrier may be subject to TRIA but we don't like their price but do like the price of some others and make the placement accordingly. If you can envision this "Swiss cheese" type of structure, you can then think of the use the sabotage and terrorism market as the difference in conditions, a hole filling mechanism to complete the placement.

<sup>20</sup> See generally Allyn & McNeff, *supra* note 7, at 843-44 (stating that the true affects of TRIA on premiums are still unclear).

There is a fair amount of interest in domestic terrorism in certain areas of the country by some businesses and governmental agencies. Some U.S. carriers are offering non-certified event coverage to full policy limit while others are offering the coverage to a sub limit. Again, a pretty chaotic situation. For "trophy risks" in New York City in particular, we are finding that the freestanding Sabotage and Terrorism market, because of its broad coverage remains attractive. When you compare all the variables, freestanding terrorism insurance can provide an attractive alternative to the TRIA depending upon the insurance carriers involved.

There is a teeny little insurance market available for nuclear, biological and chemical through that free-standing Sabotage and Terrorism market, but it is very expensive and very boutique. It is only for certain firms that feel really, really exposed.

The bottom line to all this is clear, I think TRIA's a step in the right direction. The early adopters were either required to buy by mortgage or other contractual obligations or felt themselves to be the most exposed thus creating the adverse selection issue we touched on briefly. Using Pool-Re,<sup>21</sup> a U.K. terrorism insurance entity that was established in response to the IRA attacks in the late eighties, as an example the take-up rate was very low there in the beginning. It was expensive and the coverage was very limited. But in the next decade most of the businesses in central London became purchasers of both Pool-Re and some of the ancillary open market products that serve as wraparounds to effect full coverage. So right from the beginning we knew, because of the newness and differences, just the nature of the beast in terms of the peril, the take-up rate for TRIA would be slow.

It's been said the temporary nature of the act is a problem. It is a real problem. It is a problem for the carriers and buyers. Because, you ask, do I really make the purchase of TRIA as one of the cornerstones of my risk management philosophy when it's not going to be here three years from now? And, if I renew a policy in 2004 is it going to be extended? If I renew a policy in

<sup>21</sup> See Suzanne Kapner, *New Jitters for London*, N.Y. TIMES, Oct. 17, 2001, at W1 (explaining that "Pool Re was created specifically to provide reinsurance for terror damage, backed by a government promise to pay any claims the company could not meet").

2005 is there a runoff provision or do I only have a partial year of coverage? There are all these issues that the regulations at some point will deal with. This is a new tool and it is going to take a while to be universally appreciated and understood. You always have the fallback position of stand-alone terrorism if you need broader coverage.

That is where we are now, but please regard this as an interim report. How TRIA is going to work out in the state regulatory area, and how it really affects policyholders remains to be seen.