

The Economic Effects of Federal Participation in Terrorism Risk

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Executive Summary

The catastrophic terrorist attack of September 11, 2001, fundamentally changed the way the world looks at risk—and changed the insurance industry—forever. The previously unimaginable losses sustained by insurers and reinsurers were more than one and a half times as large as the next largest insured catastrophe loss in history, and more than 30 times larger than the next largest insured terrorist loss. On a prospective basis, the United States' vulnerability to international terrorism took on new and troubling dimensions. The new economic reality is that terrorism losses are too unpredictable and potentially catastrophic to be fully covered by the private sector alone.

CHANGES POST-9/11

The 9/11 tragedy prompted both short- and longer-term changes in the insurance industry and the management of terrorism risk by the policyholder community.

- Reinsurers refused to provide or limited terrorism reinsurance coverage in new or renewed contracts. This limited the ability of primary insurers to spread their exposure to catastrophic terrorism risk.
- Without the ability to spread the risk of catastrophic losses, primary insurers sought to reduce their own exposures within the constraints of existing state regulatory requirements. For property insurance, for example, they obtained exclusions for terrorism coverage in all but five of the largest states. These exclusions did not, however, apply to workers' compensation insurance or, in most states, to the risk of "fire following" a terrorist attack. Absent exclusions for these coverages (which could leave the insurers substantially exposed to loss), many insurers tightened their underwriting standards to reflect the increased risk.
- Whether because of exclusions or the tighter underwriting environment, many commercial policyholders faced steep price increases or were wholly unable to obtain terrorism coverage. The lack of coverage, in turn, stalled real estate transactions and construction projects, disrupted product flows, and reduced employment.

In this environment, the Terrorism Risk Insurance Act (TRIA) was debated and signed into law in November 2002, approximately 14 months after the 9/11 attacks. The law provides a federal backstop for terrorism risk, and requires primary insurers to make terrorism coverage available to commercial policyholders on the same terms, conditions, and limitations as other covered types of loss. By limiting insurers' exposure to catastrophic terrorism losses, TRIA has improved the market for such coverage and has had a stabilizing influence on the economy.

This report reviews the economic impact of TRIA and provides an analysis of the likely impact on the U.S. economy were TRIA not to be extended beyond its currently scheduled December 2005 end date. The report includes analysis of data from a number of sources, including industry publications, academic research, and over 30 interviews with representatives of policyholders, lenders, insurers, reinsurers, and trade associations. Its principal authors are Professor Glenn Hubbard, Dean of the Graduate School of Business, Columbia University, and former Chairman of the Council of Economic Advisers; and Bruce Deal, Managing Principal of Analysis Group, Inc.

Based on extensive analysis, the authors conclude that there are fundamental issues specific to terrorism that make these risks very difficult for private insurers to fully absorb. Put simply, insurers' financial resources (known as capacity or surplus) to cover catastrophic terrorism events are limited, and estimating the likelihood and location of such extreme events is virtually impossible. In light of these realities, the authors do not believe that TRIA has prevented the development of additional private sector insurance or reinsurance coverage by "crowding out" such capacity. In fact, most participants in the system feel that without TRIA, insurers would be forced to reduce—rather than increase—their exposure to terrorism risk, thus leaving substantial and growing gaps in coverage.

Insurer Responses to TRIA's Expiration

Against this backdrop, the authors believe that allowing TRIA to expire would have the following effects on the insurance industry:

- Insurers will adopt terrorism exclusions or other coverage limitations wherever permitted by state regulators. It is important to note that such endorsements are currently prohibited by statute for workers' compensation insurance and limited in many states for property insurance covering the risk of "fire following" a terrorist attack.
- Where exclusions are not permitted, insurers will begin making strategic decisions to exit certain lines of business and certain geographic areas.
- Even where terrorism insurance is offered, insurers will more cautiously manage their total exposures within defined geographic areas, further reducing capacity.
- Prices for terrorism coverage that remains available may well increase, possibly significantly.

Policyholder Responses to TRIA's Expiration

These responses by the insurers will leave policyholders faced with very difficult choices between going without coverage or paying higher prices. These choices will generate the following economic effects:

- Fewer businesses and commercial properties will have terrorism coverage, particularly in urban areas, exposing more businesses of all kinds and sizes to bankruptcy in the event of a terrorist event.
- If terrorism insurance becomes more expensive or less available to commercial property owners, commercial property values will decrease and future investment in commercial property will decline.
- Reductions in the value of commercial real estate will reduce household net worth, as households are the ultimate owners of capital.
- Higher terrorism insurance costs for workers' compensation and other types of insurance may translate into job loss and job dislocation, as employers reduce or relocate their work force.

Broader Economic Effects of TRIA's Expiration

These responses by insurers and policyholders will result in lower economic performance and greater disruption to the U.S. economy in the event of a terrorist attack. The authors have estimated the impact of these changes as follows:

- Absent another major terrorist attack, GDP may be \$53 billion (0.4 percent) lower, household net worth may be \$512 billion (0.9 percent) lower, and roughly 326,000 (0.2 percent) fewer jobs may be created.
- Were another attack to occur of the size of 9/11, tens of thousands more jobs could be lost due to the lack of insurance coverage and thousands of additional bankruptcies could occur compared to the 9/11 event, which was covered by the insurance industry.

These actions and reactions would begin to be felt even before TRIA's scheduled December 31, 2005, expiration date, thus increasing the urgency of prompt Congressional action to extend TRIA.

It is the author's overall conclusion that renewal of TRIA for the near term will strengthen U.S. economic performance. Extending TRIA for two more years will allow time to evaluate possible alternative approaches to TRIA. While alternatives to TRIA (*e.g.*, capital infusions; catastrophic terrorism bonds; risk pooling) have been suggested, the authors do not believe that any of these are viable alternatives in the near term.