Terrorism Risk Insurance Act: Time to Renew . . . or Rethink?
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Abstract

This paper summarizes the U.S. program for terrorism insurance, outlines its advantages and disadvantages, and describes the current proposals for extension of the program. The program, generally referred to as a “Federal Backstop,” functions in some ways that are similar to reinsurance, but it does not require participants to pay premiums ex ante. Instead uses an ex post recoupment mechanism to recover some or all of the Federal payments made under the program. This approach has the advantage of reducing the cost and increasing the availability of terrorism insurance. Some have criticized the program for its interference in market mechanisms, but the program facilitated the development of the market underneath the backstop. The program does not cover NBCR risk, and some types of insurance are excluded. In addition, the program does not preempt state price regulation or the mandated use of the standard fire insurance policy, which provides coverage for ensuing fires after terrorism events. These weaknesses are not addressed by current proposed legislation to extend the program for seven years without any changes. The strong, bipartisan support for the proposed legislation suggests that it is likely to pass.

I. Introduction

The September 11th terrorist attacks in the United States triggered a crisis in the market for terrorism insurance. After reinsurers paid out billions of dollars to cover terrorism losses, they stopped providing coverage for terrorism going forward. This caused primary insurers to exclude terrorism losses from their coverage. Because of a perceived drag on the U.S. economy from the unavailability terrorism coverage, the U.S. adopted the Terrorism Risk Insurance Act (“TRIA) in 2002. TRIA created a unique government-industry partnership to support the development of the terrorism insurance market. This program functions like reinsurance in that it will reimburse participating insurers for a portion of terrorism losses covered by their policies, but it does not charge ex ante premiums or maintain reserves like a reinsurer would. The program has been labeled a Federal “backstop” for terrorism insurance.

This paper describes the U.S. program for terrorism insurance, and explains the basis for the government’s involvement. Because of the unpredictable nature of terrorism, the Federal backstop is needed to limit the risk sufficient to reduce the price and availability of terrorism insurance. The paper addresses some of the objections to and weaknesses of the program.

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II. Summary Description of the Terrorism Risk Insurance Program

A. Legislative History

TRIA was adopted in 2002 after insurers and reinsurers began excluding terrorism risk from insurance coverage in the wake of the September 11, 2001, terrorist attacks.\(^2\) The exclusion of terrorism risk created a drag on the U.S. economy because banks were unwilling to lend on major construction projects without terrorism insurance.\(^3\) In 2005, TRIA was extended for two years with an increase in the amount of insurers’ aggregate retention.\(^4\) In 2007, the Act was extended to 2014 and modified to include domestic terrorism, to increase the amount of insurers’ aggregate retention again, and to raise the program trigger.\(^5\) In 2015, the Act was extended to 2020, modified to increase the insurers’ aggregate retention, raised the program trigger, and revised the program in several other relatively minor ways.\(^6\)

B. Coverage Under the Terrorism Risk Insurance Program

Under current law, the terrorism insurance program requires that commercial property and casualty insurers\(^7\) offer terrorism coverage in the policies they are selling.\(^8\) The program does not set the price of the insurance (though state regulation may apply), and does not require that insureds purchase terrorism coverage.

For a terrorism loss to be covered by the program, the event giving rise to the loss must be certified as an act of terrorism by the Secretary of the Treasury in consultation with the Secretary of Homeland Security, and property and casualty insurance losses from the event must exceed $5 million.\(^9\) For the

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\(^2\) See ABA TIPS Taskforce on Federal Involvement in Insurance Modernization, Whitepaper on Renewal of TRIA at 1 (March 15, 2006) [hereinafter Whitepaper].

\(^3\) Id. at 1-2.


\(^6\) Terrorism Risk Insurance Program Reauthorization Act of 2015, Pub. L. 114-1 129 Stat. 12. The revisions reduce the share of Federal payments, increase the industry aggregate retentions for the trigger and recoupment, and adds consultation with the Secretary of Homeland Security to certify an event as an act of terrorism. See id. §§ 102-105. The Act also requires several studies and some administrative changes. See id. §§ 107-112

\(^7\) Some lines of property and casualty insurance are excluded from the program: crop, private mortgage insurance, financial guaranty, medical malpractice, health and life, flood, reinsurance, commercial auto, burglary and theft, surety, professional liability, and farm owners multiple peril. See 15 U.S.C. § 6701, Terrorism Insurance Program § 102 (11)(B).


\(^9\) See id. § 102(1).
program to be “triggered” (giving insurers benefits under the program), insurance industry losses from the terrorism event must exceed $200 million in 2020. In addition, for an individual insurer to receive benefits under the program, its losses must exceed a deductible equal to 20% of its annual direct earned premiums from the previous year. Once the deductible has been met, as of 2020 insurers will be reimbursed for 80% of insured terrorism losses.

The program has an annual cap of $100 billion (more than twice the losses from the September 11th attacks). If total insured losses exceed $100 billion in a calendar year, the program will not make additional payments, and insurers that have met their deductible are relieved of any liability that exceeds the cap.

Figure 1, adapted by the Congressional Research Service from an illustration prepared by the Congressional Budget Office, provides a graphical representation of the basic structure of the program, although it shows the aggregate loss trigger of $100 million and the individual insurer retention (co-insurance) of 15% in force in 2015. As of 2020, the program trigger is $200 million, and the individual insurer retention is 20%.

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10 Id. § 103(e)(1)(B)(i). The trigger amount was $100 million in 2015, and was increased under the program by $20 million each year until it reached $200 million in 2020. Id.
11 See id. § 103(e)(2)(B)(i) and § 102(7).
12 Id. § 103(e)(1)(A). In 2015, the federal share of insured terrorism losses was 85%, which was reduced by 1% per year (i.e. from 85% to 84% in 2016) until it reached 80% in 2020. Id.
13 Id. § 103(e)(2)(A).
14 Id. § 103(e)(2)(A)(i).
15 Id. § 103(e)(2)(A)(ii).
C. Recoupment of Federal Payouts Under the Program

The terrorism insurance program does not charge participating insurers any premiums for coverage provided by the program. Instead, it has provisions to recoup Federal payments from the insurance industry after a loss. If aggregate losses retained by insurers (due to the deductibles and insurer copayments) in 2020 do not exceed $37.5 billion, the Secretary of the Treasury is required to impose surcharges on property and casualty insurance policies to recoup 140% of difference between the industry retention and $37.5 billion. After 2020, the threshold used for mandatory recoupment changes from a fixed amount of $37.5 billion to “the amount equal to the annual average of the sum of insurer deductibles for all insurers participating in the Program for the prior 3 calendar years” as

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16 See id. § 103(e)(7). For calculations of estimated recoupment under different payout scenarios, see Webel, supra note 5, Appendix Table A-1, at 16.
specified in regulations from the Department of Treasury. The regulations specify that the insurance industry marketplace aggregate retention will be calculated by taking the three-year average of total directed earned premiums for covered insurers multiplied by 20%.

The program includes a timetable for recoupment surcharges. For acts of terrorism that occur prior after January 1, 2019, the recoupment surcharges are to be collected by September 30, 2024.

In addition to mandatory recoupment, if the losses retained by insurers exceed the mandatory recoupment threshold ($37.5 billion in 2020 and 20% of aggregate annual direct earned premiums), the Secretary has discretion to impose additional surcharges for recoupment of Federal expenditures in light of the ultimate costs to the taxpayers, the economic conditions in the insurance marketplace, the affordability of commercial insurance for small and medium-sized businesses, and other facts the Secretary considers appropriate. The discretionary surcharge is subject to at 3% limitation, and, if imposed, will be imposed for one year subject to extensions for one-year increments.

D. Backstop, not Reinsurance

The term “backstop” is used to describe this program because the Federal government stands behind the program, and facilitates it, but much of the risk, especially in the first instance, is borne by the insurance industry. Because of the deductibles, insurers bear the risk of terrorism losses up to 20% of their direct earned premium. The precise amount of this deductible will vary depending on the conditions in the marketplace and the sales of individual insurance companies, but it could be in the neighborhood of $36 billion.

Furthermore, the recoupment provisions provide that much or all of the government payments under the program would be recovered from insureds through premium surcharges. When insured losses are $37.5 billion or less (or is equal to or less than 20% of industry annual direct earned premium after 2020), the government will recoup 140% of its payout. If, for example, a terrorism event caused insured losses of $20 billion, assuming the insurance industry paid a deductible of $6 billion, the Federal

18 31 C.F.R. § 50.4(m)(2).
20 See id. § 103(e)(7)(C).
21 See id. § 103(e)(8)(C); see also 31 C.F.R. § 50.92(a)(3).
22 31 C.F.R. § § 50.92(a)(3).
23 This figure was obtained by using aggregate direct earned premium figures from the NAIC for 2012 for the commercial property-casualty insurance sector, see Webel, supra note 5, at 5, but to reach this figure, direct earned premiums would have to be evenly distributed among all insurers and all insurers would have to bear the same proportion of terrorism losses. These are very artificial assumptions, but they give some sense of maximum scope of the insurer deductibles.
24 The statute says that the mandatory surcharge applies to the difference between the lesser of the aggregate amount the insured losses or $27.5 billion (or the amount revised under the act with the passage of time), see 15 U.S.C. § 6701, Terrorism Insurance Program § 103(e)(6)(A)(i), and the amount of the insured losses retained by the insurers under the deductible and copayment provisions, see id. § 103(e)(7)(A)(ii). Where the total losses are under $27.5 billion, this amount will always be the amount paid out by the government. See Webel, supra note 5, at Appendix, Table A-1, at 16.
share of the losses would be $11.2 billion (20 billion - 6 billion x .8), so the recoupment surcharges would be for $15.68 billion (11.2 billion x 1.40). Where the losses exceed $37.5 billion (or 20% of the annual direct earned premiums), the mandatory recoupment is limited to the difference between $37.5 billion and the total amount of the insurers’ share of the losses (deductible plus copayments). Thus, if we assume a terrorism event with $50 billion in insured losses, and that the aggregate of insurer deductibles is $15 billion, the remaining insured losses would be $35 billion. Of that amount, the insurers would be responsible for a copayment of $7 billion ($35 billion x .2). The government’s share would be $28 billion. Mandatory recoupment under this scenario would be $21.7 billion (37.5 - 15 - 7 = 15.5 x 1.40 = 21.7). Although this recoupment would leave the government responsible for more than $6.3 billion of the losses (28 – 21.7 = 6.3), the Secretary of Treasury also has authority to impose additional discretionary surcharges for all or part of this $6.3 billion not covered by mandatory recoupment.

These recoupment provisions make the program much different than traditional reinsurance, which is the transfer of risk from primary insurers to reinsurers in exchange for a premium payment. Here, while there is a transfer of sorts in the sense that the government pledges to reimburse some of the losses, the Federal government doesn’t bear the risk in the same way as a reinsurer. The Federal government explicitly has the right to recover the payments through both mandatory and discretionary premium surcharges. In addition, the program does not charge any premiums. Instead of trying to predict the risks and potential costs in advance, this program pools the risk and then distributes the costs of a loss after the terrorism incident.

E. Use of Market Mechanisms

While the Federal backstop reduces terrorism risk exposure for insurers to a level that encourages insurers to underwrite terrorism risk, insurers maintain enough exposure under the program to create incentives for the operation of a terrorism insurance market. Insurers must bear 20% of their directed earned premiums as a deductible and another 20% of any losses as a copayment. Using 2012 data, the National Association of Insurance Commissioners determined that the insurers could face as much as $36 billion in exposure from the deductible provision. In addition, insurers face additional billions in exposure from the copayment provision. Thus, insurers easily face tens of billions in exposure, which is

26 The insurance marketplace aggregate retention amount is the lesser of $37.5 billion for 2020 or 20% of the three-year average of annual direct earned premiums for property and casualty insurers after 2020. 15 U.S.C. § 6701, Terrorism Insurance Program § 103(e)(6)(B)(ii). The mandatory recoupment amount is the difference between the insurance marketplace aggregate retention amount under subsection (6) and the aggregate amount off insured losses not compensated by the program because they are within the deductible or copay. Id. § 103(e)(7)(A).
27 See Webel, supra note 5, at Appendix, Table A-1, at 16.
28 See Webel, supra note 5, at 5.
29 The program has a hard cap of $100 billion. See 15 U.S.C. § 6701, Terrorism Insurance Program § 103(e)(2)(A). Insurers are reimbursed for 85% of losses (so retain 15% of the losses as a copayment). See id. § 103(e)(1)(A). Thus,
similar to the $23.9 billion in losses from the September 11th attack.30 This exposure, which exists underneath the Federal backstop, is the space where the terrorism reinsurance market operates.

III. The Terrorism Program Reduces Prices for Terrorism Insurance and Increases Availability

The primary objective of the terrorism program when it was first adopted in 2002, and each time it has been up for renewal, has been to facilitate insurance coverage for terrorism losses. The September 11th attack made terrorism risk real and concrete, and insurers learned that they were not prepared for the risk from an underwriting standpoint. Although much effort has been devoted to developing models of terrorism risk and terrorism-related losses, the nature of terrorism risk remains substantially unpredictable, which makes it difficult for the private insurance market to take on that risk at prices that insureds will pay. The terrorism program, by providing a Federal backstop, reduces the amount of risk to a level that allows the private market to operate.

A. The Terrorism Program is Needed Because Terrorism is Unpredictable

Even though a functioning market for terrorism insurance and reinsurance exists, the Federal backstop is necessary to keep the market functioning. Fundamentally, even though there has been a great deal of research since 2001, terrorism risk is still highly unpredictable.31 Acts of terrorism are deliberate, not accidental, undertaken with the intention of generating fear.32 Terrorists may act in ways that are unexpected in order to generate greater fear,33 and have shown an increased willingness to attack “soft” targets.34 Terrorists’ willingness to commit suicide makes it more difficult to predict their behavior.35 There is a relatively small amount of historical data on terrorism,36 and those data are limited by the broad range of cultural, operational, and ideological differences in terrorist groups.37 What data there are may be unavailable to insurance underwriters because of national security and law enforcement

maximum copayments are $15 billion ($100 billion x .15). To reach this figure, insurers would have to have no deductible at all, which would not happen.

30 See Henry H. Willis, Omar Al-Shahery, National Security Perspectives on Terrorism Risk Insurance In the United States at iv (RAND Corporation March 2014)[hereinafter RAND II].
32 See Whitepaper, supra note 2, at 3; see also WHARTON RISK MANAGEMENT AND DECISION PROCESS CENTER, TRIA AND BEYOND, at 13 (2005) [hereinafter WHARTON].
33 See Whitepaper, supra note 2, at 3. This has been called the dynamic uncertainty problem. See WHARTON, supra note 32, at 52-53.
34 See Whitepaper, supra note 2, at 3; see also Peter Chalk, Bruce Hoffman, Robert Reville, Anna-Britt Kasupski, Trends in Terrorism: Threats to the United States and the Future of the Terrorism Risk Insurance Act at 15-16 (2005) [hereinafter RAND I].
35 See Whitepaper, supra note 2, at 3; see also WHARTON, supra note 32, at 55-56.
37 See Whitepaper, supra note 2, at 3; WHARTON, supra note 32, at 58.
B. Unpredictability Affects Terrorism Insurance Price and Availability

Because terrorism is so unpredictable and could lead to enormously catastrophic losses, insurers have difficulty in determining an appropriate price for the coverage and the amount of capital reserves that should be maintained for the risk. The Federal backstop limits insurers’ risk to the individual insurers’ deductibles (collectively about $36 billion) and the copayment, currently 20%, which makes insurers more willing to underwrite terrorism insurance and to charge lower prices.

This benefit of TRIA is particularly acute for risks with the highest level of damages because those are the most unpredictable. An insured loss of $100 billion would be one of historic proportions. It would be more than double the most significant insured loss in U.S. History, Hurricane Katrina, which caused $47.4 billion in insured property damage (2012 dollars). Insurers faced with such risks may seek to exclude terrorism from coverage as uninsurable, or, if they continue to insure for terrorism risk, they will likely charge much higher prices. This is precisely what happened after the September 11 attacks.

38 See Whitepaper, supra note 2, at 3; WHARTON, supra note 32, at 53-54.
39 RAND II, supra note 30, at 11.
40 RAND II, supra note 30, at 12. The fundamental assumptions that limit validity of the models are that there are a finite set of attack scenarios and that the intentions and capabilities of terrorism groups can be predicted. In fact, the possible range of scenarios is limitless and it is impossible to predict the intentions and capabilities of all individuals and groups that might undertake a terrorist act. Id. Another important limitation of the modeling pointed out by RAND is that validity and reliability of the models are completely untested. Id. This problem led the U.S. National Academy of Sciences to conclude, “after reviewing a wide range of terrorism risk models at the Department of Homeland Security . . . that it ‘did not find any Department of Homeland Security [terrorism] risk analysis capability and methods that are yet adequate for supporting decisionmaking.’” Id. at 11-12 (citing National Research Council, Department of Homeland Security Bioterrorism Risk Assessment (National Academy Press, 2008)).
41 See Whitepaper, supra note 2, at 4; see also WHARTON, supra note 32, Chapter 3.2. For additional analysis of the impact of the unpredictable nature of terrorism on availability of terrorism insurance in the U.S. market, see Thomas Russell & Jeffrey E. Thomas, Government Support for Terrorism Insurance, 15 CONN. INS. L.J. 183 (2008).
42 See Whitepaper, supra note 2, at 4; see also Hartwig, supra note 36, at 11. The historical experience when TRIA was adopted supports this analysis. Insurers re-entered the market, prices dropped, and take-up rates went up. See RAND I, supra note 34, at 7.
43 See Rand II, supra note 30, at 14 (“the expected maximum losses from unconventional attacks—the types of attacks for which modeling capabilities are not valid and reliable—are likely to exceed this [27.5 billion Industry Aggregate Retention] threshold.”)
44 See Rand II, supra note 30, at 1, Table 1 (citing Property Claim Services, http://www.iii.org/facts_statistics/catastrophes-us.html).
Because of the scope of the risk turned out to be much greater than had previously been expected, reinsurers withdrew from the market and primary insurers sought, and obtained, approval from state regulators to exclude terrorism from coverage.\textsuperscript{46} With the Federal backstop, however, prices have dropped to a level that most insureds are willing to pay. The “take-up” rate for terrorism insurance is relatively stable at about 60\%.\textsuperscript{47}

C. Without the Federal Backstop, Prices for Terrorism Insurance Would Increase and Availability Would Decline

Both the current unpredictability and the historical experience with terrorism insurance coverage suggest that without the government backstop, the cost for terrorism insurance will go up and the availability (or “take-up” rates) will go down.\textsuperscript{48} When the program was up for renewal at the end of 2014, some insurers started excluding terrorism losses on renewal policies with terms that extended into 2015.\textsuperscript{49}

\begin{itemize}
  \item \textsuperscript{46} See Whitepaper, \textit{supra} note 2, at 1 & nn. 4-5; see also Rand II, \textit{supra} note 30, at 18 (“In the aftermath of the attacks, private reinsurers who had underwritten the largest portion of insured losses at the World Trade Center ceased to reinsure terrorism risk in the United States, and by February 2002 commercial exclusions for terrorism were approved for use in 45 states.”); Michel-Kerjan, \textit{supra} note 45, at 4.
  \item \textsuperscript{47} See RAND II, \textit{supra} note 30, at 18. Webel, \textit{supra} note 5, at 11 (citing Marsh, Inc., 2013 Terrorism Risk Insurance Report at 12 (May 2013); Michel-Kerjan, \textit{supra} note 45, at 5. It is worth noting, however, that a take-up rate of 60\% means that 40\% of insureds are not purchasing terrorism insurance so that in the event of a terrorism loss, those insureds will not have coverage. See id. Virtually 100\% of the losses from the September 11\textsuperscript{th} attacks were covered by insurance because terrorism was not excluded. \textit{id}.
  \item \textsuperscript{48} See RAND II, \textit{supra} note 30, at 18-19 (noting that “industry experts project significant contraction of the amount of terrorism insurance offered if TRIA were not to be renewed”); Hartwig, \textit{supra} note 36, at 11 (noting that “Aon estimates that 70\% to 80\% of the market would encounter terrorism exclusions if the program were discontinued”); Rodd Zolkos, \textit{Risk Managers Fear Insurance Gaps if TRIA is Allowed to Lapse: Survey}, Business Insurance (Oct. 29, 2013) (44.9\% of risk professionals reported that allowing the Federal backstop to expire would decrease their terrorism coverage limits and 23.8\% report that they think terrorism coverage would not be available without the Federal backstop); Marsh Risk Management Research, Market Update, 2013 Terrorism Risk Insurance Report at 19 (May 2013) (projecting that because of finite capacity of the stand-alone terrorism market, the cost of terrorism insurance could be five to ten times higher than under the Federally-backed terrorism program, and that capacity in some areas could be so limited that only 10\% of the current Federally-backed terrorism insurance would be available in the stand-alone market).
  \item \textsuperscript{49} See, e.g., Arthur D. Postal, \textit{Market is Already Reacting to Possible Inaction on TRIA, Industry Rep Says}, PropertyCasualty 360 (February 25, 2014), \url{http://www.propertycasualty360.com/2014/02/25/market-is-already-reacting-to-possible-inaction-on#.Uw0OBAqoUn4.email} [last visited March 13, 2014]; Brian J. Green, \textit{The Future of TRIA}, Risk Management Magazine (February 20, 2014) (“Insurers have issued, and are continuing to issue, policies that extend beyond the program’s expiration at the end of the year. They are also including conditional language for the post-Dec. 31 period in which TRIA may not exist, or may not exist on its current terms. But some insurers are not offering post-Dec. 31 terrorism coverage at all.”), \url{http://www.rmmagazine.com/2014/02/20/the-future-of-tria/} [last visited March 25, 2014]; Unease Over Terror Insurance Rattles Market, Commercial Mortgage Alert (November 1, 2013) (“Zurich North America told insurance brokers and consultants this week that starting in January, policyholders will be notified that their terrorism coverage could be altered, or premiums increased, if the government program lapses. A recent memo from Liberty Mutual was more direct, saying if the program isn’t
IV. Limitations of the Terrorism Program

A. The Program Interferes with the Market for Terrorism Insurance

One of the primary criticisms of the terrorism program is that government involvement interferes with the development of the private market for terrorism insurance. Critics argue that with time the private market for terrorism insurance would develop. Perhaps this is true; the limited experience with the market for terrorism insurance provides some basis for arguments on both sides of this issue. On one hand, after the September 11th attack, insurers left the market for terrorism insurance. On the other hand, much work has been done on risk modeling since that time, and terrorism insurance is available (albeit with the Federal backstop in place). If the Federal government were to close down the Terrorism Insurance Program, some insurers would likely provide some terrorism coverage, though most agree that the cost would be higher and take-up rates lower.

Even though the program does interfere with the development of the private insurance market, the structure of the program has promoted the market for terrorism has developed underneath the Federal backstop. The industry retention and insurer deductibles create an incentive for the market to develop, but without the backstop insurers would not have been willing to take on high levels of terrorism risk. Thus, the backstop, as a government-supported pool to cover the most catastrophic losses, facilitated some development of the market for terrorism insurance.

B. The Program Requires Federal Expenditures

Another criticism is that the Federal terrorism insurance program is too costly. A study done by the Congressional Budget Office estimated that extending the terrorism insurance program in 2007 would “increase direct spending by $3.1 billion over the 2008-2012 period and by $6.6 billion over the 2008-2017 period [with an] . . . additional $1.1 billion” to be spend after 2017. These figures make the

_renewed, it will end coverage for certain terrorist acts. ")


terrorism program look significant. However, these figures are based on pay-out assumptions that turned out to be incorrect. These figures were calculated with the assumption that the program would pay out on average about $2.3 billion annually. In fact, there have been no payments made under the Federal terrorism insurance program since its inception in 2002. Thus, the actual costs under the program have been negligible.

At the other end of the spectrum, some have criticized the program on the ground that the Federal backstop is provided “for free.” Those covered by the program receive the benefit of the backstop without paying for it, and therefore some characterize this as a kind of government subsidy. The CBO estimated that the value of this benefit, using insurance principles, would be approximately $1.1 billion per year. Although one might suggest that there be some kind of a “premium” for participation in the program, which would be consistent with the way reinsurance works (and is consistent with the approach taken in other countries), this would divert capital from the market for a risk that is highly unpredictable. For example, in the U.K insurers pay the terrorism pool 0.03% or 0.006% of their property premiums depending on the location of the property, resulting in current reserves of approximately £4.7 billion (US$7.34 billion). One can argue that it would be prudent charge insurers for the benefit of terrorism coverage to create reserves for a terrorist incident. This is the traditional way insurance handles risks. But creation of terrorism reserves would take capital away from other potentially more productive uses. In addition, the basis for setting a reserve of any particular amount is, at best, speculative. Furthermore, by charging a premium and holding reserves, the program would be acting more like a reinsurer and would be an even greater market intrusion than the Federal backstop. Charging a premium for the program would require underwriting decisions about the price of the benefits provided by the program, which would be extremely difficult to do accurately because of the unpredictability of terrorism risk.

Instead of setting the price for participation in the program ex ante, the Federal backstop uses the recoupment mechanism to set the “price” for benefits of the pooling mechanism after a terrorist event. This makes the ultimate cost of the program much more accurate than an ex ante approach. Depending on the circumstances, the Secretary of Treasury may be required to impose up to a 3% premium surcharge on property and casualty insurance, or may have discretionary authority to determine the particulars of the surcharge. For those years that there are no certified terrorist incidents (that is, for nearly nineteen years of the program, from 2001 until the present), the cost of the program has been minimal. For those years in which there is a terrorism incident, the government may recover some or all of its costs, or in some scenarios, recover even more than it spends. For example, the Congressional

52 Id. at 6.
54 Congressional Budget Office Cost Estimate, supra note 51, at 7.
56 See Michel-Kerjan, supra note 45, at 10.
Research Service estimated that a terrorism incident with covered losses of $27.5 billion would require the Federal government to pay $16.4 billion, but would generate $21.8 billion in recoupment, for an excess of $5.4 billion.58

Of course, not all scenarios would generate an excess for the government. In the event of a terrorism incident that causes $100 billion in insured losses, the Congressional Research Service (making certain assumptions about which provisions of the program applied) found that the Federal government’s share of the losses would be $59.5 billion, of which none would be subject to mandatory recoupment.59 That amount would be subject to discretionary recoupment, which requires the Secretary to take into account recoupment the costs to taxpayers, the economic conditions in the insurance marketplace, the affordability of commercial insurance for small and medium-sized businesses, and other facts the Secretary considers appropriate.60 This could leave a substantial burden on taxpayers, but a terrorism event of this size would be unprecedented. Consequently, even if the terrorism insurance program was not in operation, it is likely that the Federal government would step in and provide disaster assistance.61

If one assumes that the government would step in, the terrorism program has the benefit of encouraging insurers to participate at some level thereby reducing the Federal government’s costs by some $40 billion in a worse-case scenario. In addition, the industry retention in the terrorism insurance program promotes market mechanisms to encourage pre-event planning,62 and provides some administrative capacity for claims processing.

C. The Program is a Subsidy for Insurance Companies

Because of the low cost of the program to insurers, some have suggested that the Federal terrorism insurance program is a kind of “corporate welfare.”63 That phrase is used as a kind of ad hominem attack on programs that are seen as providing a government benefit for large companies. The pejorative notion of “welfare” is the use of government power for a kind of wealth-transfer from taxpayers to corporations. Although insurers and insureds receive a benefit from the program, in the abstract this is not a wealth transfer from taxpayers to insurers because insurers, in a free market, would be free to exclude terrorism coverage from their policies. While it is true that the Federal backstop provides a pooling mechanism for high levels of terrorism risk that provide sufficient protection for insurers to undertake some insurance of terrorism risk, and that the insurers receive the benefit of premiums for insurance they sell, the recoupment mechanism in the program puts much, perhaps all, of the cost of the program back on the insurance market. Those covered by insurance receive a more direct benefit from the terrorism insurance program than do insurers (who otherwise would just exclude terrorism.

58 See Webel, supra note 5, at Appendix, Table A-1, at 16.
59 See id.
60 See supra note 57.
61 Cf. Michel-Kerjan, supra note 45, at 7 (predicting that the President would likely declare a disaster and provide Federal assistance in the event of substantial terrorism losses that are uninsured); see also Levmore & Logue, supra note 50, at 278-295.
62 See Whitepaper, supra note 2, at 5-6.
risk), but insureds also would pay the premium taxes used to recoup the cost of Federal payments after a terrorist attack.  

Because all property casualty insureds would pay the surcharges to recoup the cost of payouts under the program, the insurers who receive reimbursement under the program are being subsidized by insurers (and insureds) who do not receive direct benefits from the program. Insurer deductibles and copayments are borne by insurers whose insureds chose to buy terrorism coverage and who suffer terrorism losses. The recoupment, however, is not limited to those insurers who benefit from the program. The recoupment surcharges apply to all property and casualty insurance covered by the program. Even though a terrorism incident may be catastrophic, its damages will be localized. A bomb in New York does not damage property in Chicago or Los Angeles. Yet insurance consumers in Chicago, Los Angeles, Des Moines, and throughout the United States will pay the surcharge for recoupment. In addition, not all insureds have terrorism coverage. Take-up rates for terrorism coverage have been stable around 60% for some time. Yet all consumers will pay the recoupment surcharge regardless of whether they chose to purchase terrorism coverage. This cross-subsidy may be addressed to a limited extent by the Secretary’s ability to adjust the recoupment surcharge for geographic and market considerations. This could perhaps reduce the subsidy from some sources, such as certain rural areas or lines of insurance that have lower terrorism risk, but reduction of that subsidy would have to be offset by increased subsidy from others. Moreover, the surcharge is fundamentally designed to be over-inclusive to create the desired pooling effect, so there is an inevitable cross-subsidy. This kind of subsidy is common in insurance, where premiums are paid by many but claims are made by only a few, but the difference is the amount of the subsidy is determined on an actuarial basis in light of the amount of risk. The weakness of the recoupment mechanism is that it is not based on an actuarial calculation of an individual insured’s risks.

Even though the program will allocate much, or even all, of the cost of a payout to the insurance industry, the Federal government still bears some risk under the program. One justification for having the government bear this risk is that, from an actuarial standpoint, the government is in the best position to combat terrorism through the use its intelligence services, law enforcement, and military power. All taxpayers provide financial support for these anti-terrorism efforts and benefit from them. The Federal backstop for terrorism insurance is a reasonable extension of these efforts, especially when the private sector cannot get access to intelligence and law enforcement information about terrorism that might be used for modeling purposes. Because the government has better access to the information about terrorism risk, and is in a better position than those in the private sector to reduce that risk, it is reasonable that the government should bear some of the consequences of terrorism risk.

D. The Program has Limited Coverage

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64 For an argument that the government-industry partnership is the optimum approach and should continue, see Alexia Brunet Marks, Under Attack: Terrorism Risk Insurance Regulation, 89 N.C. L. Rev. 387 (2011).
84 See id. § 103(e)(8)(D)(ii).
65 See Whitepaper, supra note 2, at 3-4.
One of the limitations of the program from its very outset has been the scope of the program’s coverage. A number of critics have raised concerns that the programs does not cover nuclear, chemical, biological, and radiological (sometimes referred to as “NCBR”) attacks. Although the program was amended to include domestic terrorism, the extensions and amendments did not provide any coverage for NCBR attacks. The program only requires that insurers offer terrorism insurance to their policyholders on the same terms and conditions as property and casualty coverage for non-terrorism losses.66 Because most property insurance policies have long specifically excluded losses from nuclear events and for release of contaminants, which would likely exclude coverage for chemical, biological and radiological materials, TRIA does not require terrorism insurance to cover such events.67 The absence of coverage for NCBR attacks represents a significant gap in insurance coverage for terrorism. Models have shown that a large-scale biological attack, such as with anthrax, could generate as much as $90 billion in losses.68 Nuclear or radiological attacks could have an even more severe impact. A “dirty bomb” could contaminate an area as large as ten square miles requiring demolition on a massive scale and astronomical losses.69 The RAND study concluded that the “most profound risk” of uninsured losses is in the area of a NCBR attack.70 A previous extension of the program included a requirement to study the NCBR issue. A study issued in December 2008 by the Government Accountability Office confirmed that insurance coverage for NCBR risk is not available in the market.71 The GAO also found that some insurers were in favor of extending TRIA to cover NCBR risks, while others preferred that the government set up an insurance program to insure NCBR risks directly. The latter proposal was criticized as exposing the government to substantial losses.72

A second limitation is that the program does not cover all lines of insurance that are at risk of terrorism losses. Initially, the program covered commercial property & casualty insurance, including workers compensation and automobile coverage.73 Health and life insurance, including group life, were not covered.74 When extended, the program was amended to omit commercial automobile, burglary and theft, surety coverage, professional liability, and farm owners multiple peril insurance, and amended to specifically add coverage for directors and officers liability.75 Health and life insurance, including group

67 Chalk, et. al., supra note 34, at 6-7; Wharton, supra note 32, at 81. It should be noted that workers compensation insurance is a notable exception to this because of the mandatory scope of coverage of workers compensation insurance. Id. at 81.
68 Wharton, supra note 32, at 50.
69 The American Academy of Actuaries estimated that a large NCBR attack in New York City could cause as much as $778 billion in insured losses. See Terrorism Risk Insurance Subgroup, American Academy of Actuaries, Open Letter to President’s Working Group on Financial Markets: Terrorism Risk Insurance Analysis (April 21, 2006), http://www.actuary.org/pdf/casualty/tris_042106.pdf (last visited on March 13, 2008). This is some 20 times more than the losses caused by the September 11th attack, and is nearly 8 times the annual cap provided by TRIA.
70 Chalk, et. al., supra note 34, at xii.
72 Id. at 7-8.
life, continue to be outside the scope of program.\textsuperscript{76} This creates a significant coverage gap. The September 11\textsuperscript{th} attack generated $1 billion in losses for life insurers.\textsuperscript{77} A nuclear, chemical, biological or radiological attack could substantially increase such losses. In addition, because group life insurance policies are sold to groups of employees, they present a concentrated risk that could magnify the impact of a terrorist attack for a single carrier. While the level of terrorism risk is significant for health and life insurance, the Treasury Department chose not to include group life insurance in the program because it found that group life insurers continued to offer insurance after the September 11\textsuperscript{th} attacks.\textsuperscript{78} Thus, terrorism risk may not be so high that it creates any difficulty in providing sufficient capital to underwrite the risk for health and life insurance.

E. The Program Does Not Fully Preempt State Regulation of Terrorism Insurance

Although because of Federal supremacy the Federal terrorism insurance program over-rides inconsistent state regulations, the program allows continuing state regulation in the areas of pricing and with regard to the required coverage for ensuing fires. In an effort to allow the market mechanisms to operate, the program did not set any prices for terrorism insurance. However, the program allows state regulation of insurance prices, including for terrorism insurance, to continue. In the first year of the program, the states’ prior approval of rates (and any applicable “waiting period) was preempted.\textsuperscript{79} Thus, federal law preempted state regulation for the first year only.

State regulation of pricing for terrorism insurance varies from state to state. Although the Insurance Services Office developed a methodology to price terrorism risk, and suggested that a price of $0.10 per $100 of value for property coverage would be appropriate in high risk cities, regulators in New York and District of Columbia, approved $0.03 and $0.018, depending on the property.\textsuperscript{80} Other states have taken other approaches that have kept down the rates for terrorism insurance.\textsuperscript{81} Regulators have taken a similar approach to the suggested pricing model developed for workers compensation coverage.\textsuperscript{82} None of the states has adopted pricing at the level that was suggested by the Insurance Services Office. Some states used regulatory authority to lower the price requested by insurers, while others used their regulatory power to negotiate adjustments to the proposed pricing model.\textsuperscript{83}

Although lower rates in some states may improve access and the willingness of policyholders to buy terrorism coverage, price differentials create inequity from state to state. State rate regulation also makes it more difficult for insurers to charge an appropriate premium. Another consequence of state pricing regulation is that it interferes with the development of the reinsurance market. When state

\textsuperscript{76} Id. § 102(11)(B)(v).
\textsuperscript{77} Wharton, supra note 32, at 44.
\textsuperscript{78} Wharton, supra note 32, at 17.
\textsuperscript{79} Terrorism Risk Insurance Act § 106(a)(2)(B), Pub. L. No. 107-297, 116 Stat. 2322. It should be noted, however, that even this preemption left room for state regulation because it excepted from preemption “the ability of any State to invalidate a rate as excessive, inadequate, or unfairly discriminatory.” Id.
\textsuperscript{80} American Insurance Association, How the Free Market Fails (April 2005).
\textsuperscript{81} Id.
\textsuperscript{82} Id.
\textsuperscript{83} Wharton, supra note 32, at 84-88.
regulators require that premiums be less than the market price, insurers have less resources available to
purchase reinsurance (which will be at market prices because reinsurance is not subject to price
regulation). There is some evidence that the pricing for primary terrorism coverage is interfering with
development of the reinsurance market. The Wharton study found that “there is relatively little private
insurance to cover portions of losses below the [Federal terrorism program] deductible in urban areas
and/or the price of reinsurance is prohibitively high relative to the premium that insurers can charge for
coverage to commercial firms.”

State regulation that requires coverage for ensuing fires (based on the New York standard fire insurance
policy) also interferes with the ability of the terrorism insurance program to rely on market forces. At
the time of the September 11th attacks, 29 states required commercial property insurance to conform to
the coverage of the so-called “standard fire insurance policy.” This mandated that property insurance
provide coverage for fires that ensue from a terrorist event even if other damages from the terrorist
events are specifically excluded by the policy. After the Federal terrorism program was adopted,
thirteen states modified their statutes to exclude in various ways ensuing fire coverage caused by acts of
terrorism. At present, ensuing fire coverage for terrorism events mandated in 14 states. Although
this is a relatively small number of states, it includes California, Georgia, Illinois, Massachusetts, and
New York, which have large population centers and cities that are high risk targets. Such state
mandated coverage raises concerns similar to those of pricing regulation: it is inequitable to insurance
carriers because insurers in other states may be more able to collect a premium for terrorism coverage,
and, unless the regulators permit higher prices because of the ensuing fire coverage, it reduces the
ability of insurers to buy reinsurance for the terrorism risk mandated by the ensuing fire provisions.

V. Current Proposals and Conclusion

84 Wharton, supra note 32, at 19-20.
85 Wharton, supra note 32, at 85.
86 New York State Insurance Department, General Counsel Opinion Regarding Commercial Property Insurance
Terrorism Limitation for Fire Following (June 26, 2003), http://www.ins.state.ny.us/rg030627.htm [last visited Nov.
4, 2005].
87 See Standard Fire Policy vs. Non-Standard Fire Policy States, AAIS Website,
http://www.aais.org/terrorism/SFP_NSFPchart.html [last visited on May 14, 2009]. See also Wharton, supra note
32, at 85 (a chart showing twelve states that had adopted amendments). The additional state not reflected in the
Wharton report is Pennsylvania.
88 See TransRe, Fire Following Terrorism: An Approach to Estimating Loss Potential (2017) (showing the fourteen
states as California, Georgia, Hawaii, Illinois, Iowa, Maine, Massachusetts, Missouri, New York, North Carolina,
also Wharton, supra note 32, at 85 (chart showing seventeen states). The Wharton study showed Pennsylvania as
a state that required the standard fire policy but had not adopted an amendment to allow the exclusion of
terrorism. However, legislation was subsequently passed allowing the exclusion. See 2006 Pa. Laws 104. See also
Standard Fire Policy vs. Non-Standard Fire Policy States, AAIS Website,
http://www.aais.org/terrorism/SFP_NSFPchart.html [last visited on May 14, 2009]. The actual number at the time
of the Wharton study may have been 15, as Wharton shows Delaware as a standard fire policy state, whereas the
AAIS website shows that it is not.
89 See also Wharton, supra note 32, at 85
Current proposals to extend the terrorism insurance program do not address any of its perceived weaknesses. Instead, they simply extend the program for seven more years. The House of Representatives recently passed H.R. 4634, which was introduced by Congresswoman Maxine Waters, by a 385-22 margin, showing broad bipartisan support.90 This bill would extend the terrorism insurance program for seven years, but otherwise leaves the program the same.91 The one addition to the program is the instruction to the Comptroller General to conduct a study on cyber terrorism. The study is to address the U.S. vulnerability to cyber attacks, “whether State-defined cyber liability under a property and casualty line of insurance is adequate coverage for an act of cyber terrorism,” whether risk of cyber terrorism “can be adequately priced by the private market,” and whether coverage by the Federal terrorism insurance program would be appropriate for a cyber terrorism event.92 The Senate has taken up S. 2877, which was unanimously approved and reported out of the Senate Banking, Housing and Urban Affairs Committee.93 The Senate version of the bill is virtually identical to the House version,94 except that the Senate version does not address the Statutory Pay-As-You-Go-Act of 2010.95

If this new legislation is passed and signed by the President, which seems fairly likely, the Terrorism Insurance Program will continue for another seven years. Insurers will continue to mandated to offer terrorism insurance for commercial property and casualty insurance as defined by the act, and the Federal backstop will provide support for market mechanisms so that terrorism insurance will be widely available at relatively low cost. Should a major terrorist event take place in the next seven years, the program will provide reimbursement for a substantial portion of the insured losses, and insureds will be required to pay a surcharge used to recoup some or all of the Federal costs associated with the payout. This, of course, assumes that the attack is not a NBCR attack, in which case no insurance coverage would be available under current practices. To the extent that the program is interfering with market mechanisms, that interference would continue, but at the same time the support of the Federal backstop would allow additional time for the market to develop underneath the backstop. Because the program relies on recoupment instead of premium charges, it will not require significant capital investment or government resources unless a major terrorist attack takes place.

92 Id. § 2(d).
95 See Terrorism Risk Insurance Program Reauthorization Act of 2019, S. 2877, 116th Congress § 3 (2019) (version referred to Senate on Nov. 19, 2019). The Pay-As-You-Go-Act of 2010 was a deficit reduction initiative, requiring that new financial commitments be offset by new revenue or spending cuts. The House bill provides: “The budgetary effects of this Act, for the purpose of complying with the Statutory Pay-As-You-Go-Act of 2010, shall be determined by reference to the latest statement titled “Budgetary Effects of PAYGO Legislation” for this Act, submitted for printing in the Congressional Record by the Chairman of the House Budget Committee, provided that such statement has been submitted prior to the vote on passage.” Id.