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The Betterley Report

THE TERRORISM COVERAGE MARKET AND TRIA:

Specialized Coverages When TRIA Isn't Enough

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Editor's Note: In this issue, we investigate the specialized (stand-alone, non-Terrorism Risk Insurance Act [TRIA] of 2002) coverages available from the commercial market for terrorism risks. We concentrate primarily on property coverage, although we are also offering comments on casualty protection where appropriate. In this report, when we refer to terrorism coverage, we are referring to stand-alone property, unless we specify otherwise.

While we do not intend this report to be an examination of TRIA, we do discuss some of the details of TRIA coverages in an attempt to highlight the reasons why a healthy stand-alone market is needed. Good information about TRIA is available from a variety of sources.

This issue is somewhat different in format from our regular Market Surveys. Because the terrorism market is so thin and there is little in the way of negotiable points, we have limited our tables to those items that we think are most critical for the Risk Manager and his or her advisors to understand. Where we have presented information, we generally quote the relevant language in its entirety. This allows the reader (we hope) to fully understand the nuances in the coverages.

We understand that there are ten (up from seven) carriers active in the U.S. terrorism marketplace, including ACE, AIG and Lloyd's of London (the three most prominent players), as well as AXIS Specialty, Allied World Assurance (AWACS), Berkshire Hathaway, Endurance Re, Everest Re, Montpelier Re and Renaissance Re. ACE, AIG and Lloyd's are the most active and information about their products is generally available, so we concentrated on them. We have reported on the other seven as well, but find that their coverages are much more customized—not easily analyzed in a publication format.

We would like to acknowledge the assistance of Aaron Davis (21/441-1144) of AON, who assisted us in gathering information used in this report, and Chris Yaure of ACE-U.S. (215/640-1910), who contributed information about his company.

In the use of this material, the reader should understand that the information applies to the standard products of the carriers, and that special arrangements of coverage, cost and other variables may be available on a negotiated basis. Professional counsel should be sought before any action or decision is made in the use of this information.

NEXT ISSUE:

CYBERRISK MARKET SURVEY:
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INTRODUCTION

With Middle East tensions continuing to rise, insureds continue to be concerned about the inadequate insurance protection found for terrorism risk. The stand-alone market has seen a slow take-up of policies, and, for many, TRIA-based coverages do not offer enough protection coverage—and seem expensive to boot.

The global insurance market has reacted vigorously to the terrorism attacks of September 2001. The industry lobbied for a federal government-supported answer to the difficulties of insuring the unknown, while at the same time capacity was created to support specialized, stand-alone coverages. Yet most insureds still are not buying coverage for terrorism risks.

Why not?

TRIA PROTECTIONS

The Terrorism Risk Insurance Act of 2002 provides a reinsurance mechanism for commercial property and casualty insurance companies in the U.S. to protect against certified terrorism attacks resulting in damage that exceeds $5 million. The Act expires in 2004, with an optional renewal to the end of 2005. The TRIA program has a limit of $100 billion.

Excellent summaries of TRIA can be found in various insurance publications, as a well as on the Web at <http://vu.iiaa.net/Terrorism.htm>.

ISO (<http://www.iso.com/filings/response.html>), which is responsible for the implementation of much of the insurance industry's response to TRIA, has good information on its site as well.

While it was perhaps the best the insurance industry and its customers could get from Washington, TRIA has its limitations including:

- Does not apply to damage resulting from non-foreign (domestic) terrorist acts.
- The Act expires at the end of 2004, with an optional extension through 2005.
- Coverage requires the act leading to the claim be certified by the Secretary of the Treasury.
- For target insureds, TRIA coverage options may not be attractively priced.

From the industry's standpoint, it is clear that a government supported solution is necessary. TRIA is probably a good solution for most insureds with properties outside of target geographic areas, but for the many properties in the target zones, stand-alone coverage should be seriously considered.

For some insureds, the desire for terrorism coverage is simple—they understandably want to be protected against perils that were traditionally insured, and terrorism certainly meets that criterion. Other insureds have more severe problems, facing demands by lenders that they have terrorism protection.

Insurance companies have been implementing TRIA as required by the Act, so we now can see the reactions of insureds to the cost and perceived value of the coverage. It seems that a significant majority of insureds, when offered the opportunity to buy terrorism coverage through TRIA, have been concluding that there is not enough coverage and that it is too expensive.

The conclusion that TRIA coverage is too expensive may be the result of the weak economy and other demands on insurance budgets of the insureds. If the economy was good, and we were not in the middle of a hard insurance market, the cost of TRAI coverage might not be seen as unreasonable. In fact, the cost of TRIA coverage is probably quite reasonable, considering the difficulty in pricing the risk (which should mean a higher risk premium for the insurance companies).

Stand-alone coverage, of course, is not cheap. It is expected that TRIA coverage would be significantly less expensive than stand-alone coverage, given comparable insureds. But stand-alone coverage has the benefit of protecting against domestic terrorism, and is not vulnerable to the certification process or the need for TRIA to be extended.

IMPACT ON CAPTIVE INSURANCE COMPANIES

U.S. domiciled captive insurance companies are significantly impacted by a TRIA. For a U.S.-based captive insurance company offering property insurance (TRIA would apply to all U.S. captives and Risk Retention Groups, but since the terrorism exposure is primarily a property insurance problem, we are focusing on it here), there is a substantial problem—but, possibly, an opportunity.

The problem that TRIA creates for captives is that all insurance companies, even captives, are required to offer coverage for certain types of terrorism losses, yet the reinsurance it backstops for these losses is subject to a substantial retention. This retention is equal to 7 percent of earned premium in 2003, 10 percent in 2004, and 15 percent in 2005.

Many, if not most captives are inadequately capitalized to handle this risk. Existing reinsurance for these captives would not include protection against terrorism related losses. It is expected, though, that stand-alone terrorism markets will be interested in providing support for the loss exposure resulting from the implementation of TRIA.

The regulatory impact on smaller captives may well be severe. Captive regulators often ask them to describe in detail new products that Date might offer, and to provide a feasibility study to examine the impact of those products. We would expect that terrorism coverage offered by captives would be considered as new products.

In addition, the federal reinsurance is a 90 percent quota share basis (the captive absorbs 10 percent), and the U. S. Treasury can recoup its payment through a 3 percent maximum charge against the primary carrier's earned premium. Inadequately capitalized captives not only take on a new risk, they do not have 100 percent reinsurance, and they will be required to repay the government for the benefits received.

Fronting is affected as well. Undoubtedly captives will be required to take all of the risk, and the increased cost, TRIA imposes on the fronting carrier.

The right thing to do? Difficult for many captives? Absolutely!

There is some good news, though: for large and/or well-capitalized captives, TRIA creates access to reinsurance that may not be easily available in the commercial marketplace. Although it will place the same regulatory and financial burden on these captives, the benefits of access to the federal reinsurance program could be a blessing.

CARRIERS OFFERING TERRORISM COVERAGE

We are aware of ten carriers offering U.S. insureds stand-alone terrorism coverage, with an additional carrier offering coverage specifically to European Union insureds. While the ten we review here concentrate on insureds based in the U.S., the coverage can be written for their locations anywhere that meet the underwriting criteria (i.e., the location covered does not have to be located in the United States).

These ten carriers are:

- ACE USA
- Allied World Assurance (AWACS)
- American International Group
- AXIS Specialty
- Berkshire Hathaway
- Endurance Re
- Everest Re
- Lloyd's of London syndicates (various)
- Montpelier Re
- Renaissance Re

Underwriting Criteria and Market Focus

Carriers offering terrorism coverage are not taking a traditional approach to defining markets—which insurers often segment by size of insured, industry or geographic location. Instead, they are considering coverage for all potential insureds, but underwriting them individually.

The key criteria are:

1) How valuable a target is your company or facility?

2) Where is it located? and

3) Is it clustered with other targets?

In other words, it is not so much what type of industry you are in, or the size of your company; it is whether or not your facility is a valuable target, attack on which will result in advancing a terrorist's goals.

The word we keep hearing in this regard is *icon*. An iconic target, one that is viewed as a highly visible representation of the culture offensive to the terrorist is most likely in need of coverage, but also (of course) most likely to be difficult to insure.

Location may make a target more (or less) of an icon. Lower Manhattan is a far tougher location to insure than rural America; governmental officials and property owners may object, but the clear facts would seem to support the higher rates found in these areas.

Finally, the facility's proximity to other targets is also important. There are two reasons for this. First, the facility may be damaged or destroyed by an attack on another (unrelated) facility—a victim of so-called collateral damage. Second, the insurer is very concerned about accumulation—the exposure that arises because multiple insureds are affected by a single loss. The lessons of the World Trade Center attacks are making underwriters appropriately cautious about their total exposure from multiple insureds who may be damaged in a single occurrence. Thus underwriters are charging more for and limiting availability of terrorism coverage in locations subject to accumulation of exposures.

This last item is critical for an understanding of the terrorism market. An otherwise attractive risk may not be able to buy coverage if located in an area subject to terrorist attacks, where numerous other insureds have used up the capacity. An important lesson here: coverage may not be available if an insured waits too long to secure it. And, it may not be a matter of paying a higher price—when the capacity is gone, it may be gone until next year—or even later.

Carriers look at narrowly-defined areas as subject to accumulation risk. We understand, for example, that accumulation risk is measured for all insured exposures located within two-block areas of New York City. Thus, an insured will be underwritten in part based on whether it is located within a two-block proximity to other insureds.

As to the special characteristics of each carrier, AIG is most interested in domestic U.S. risks, and can be quite competitive when it is considering a desirable risk. Lloyd's of London has its traditional and appealing advantages of innovation and easy access to underwriters, but of course one needs to visit with a number of underwriters in order to get a line filled out. With terrorism coverage, this downside is acceptable.

Capacity

There is more capacity for terrorism property insurance coverage than many people think, perhaps not as much as had originally been hoped, and certainly not as much as is needed.

Of the ten carriers we have reviewed in this report, the following limits per location are reported to be available:

- ACE USA—$65 million
- AIG—$100 million
- AWAC—$5 million
- AXIS Specialty—$100 million
- Berkshire Hathaway—$500 million
  (we have heard that as much as $1 billion may be available)
- Endurance Re—$5 million
- Everest Re—$10 million
- Lloyd's of London—$200 million
- Montpelier Re—$10 million
- Renaissance Re—$50 million

There are some indications that as much as $1 billion can be obtained for a single insured by stacking up limits from several carriers, but this is not easy to do, and has been done only infrequently. Limits of $5-$200 million per location are more commonly placed, but as the market matures, additional capacity should yield more limits available per location insured.

Retentions

Property Damage deductibles have a wide range, from $25,000-$50 million.

ACE has a typical deductible of 2 percent of the Total Insured Value, subject to a minimum deductible of $100,000.

AIG reports that the norm for deductibles of 2 percent of the total insured value at each location involved in a loss, subject to a minimum deductible of $25,000 with a 30-day minimum waiting period for Business Interruption. The waiting period can alternatively be stated as a dollar amount if the insured is more comfortable with that approach, but it will still equal an amount similar to 30 days of exposure.

Lloyd's typically requires deductibles ranging from $50,000-$50 million, with $25 million and up a good range for many insureds. A 30-day wait for Business Interruption is also common.

We have been unable to find any reliable information about the deductibles required by the other for insurers. We believe that this is because each of the deals they might write is unique.

Rates

As can be expected, there is little in the way of model pricing for these policies. Premiums are based upon exposure (values, location and security). Though rates have come down since 2002.

Since the coverage is typically written net line (without reinsurance support), the premium is typically based on the rate on line. We had seen rates that range from .5 to 1 percent of the value insured, i.e., $1-$2 million premium per $100 million of limit. The typical rate, if there can be said to be a typical rate, is 1.5 percent of the limit insured. However, we have also seen premiums of as much as $10 million per $100 million of limit in New York City locations.

Cancellation/Multi-year Terms

Cancellation and length of contract terms are a concern with terrorism coverage.

Cancellation clauses in the ACE, AIG and Lloyds policies allow 30-day notice of cancellation (although both are presumably subject to local laws that restrict the opportunity to cancel except for nonpayment of premium).

While such unfavorable cancellation provisions may be understandable from the carrier's standpoint, this raises a concern as to whether the underwriter could elect to eliminate coverage during a high-threat situation.

For example, if terrorist activity increases, might the carriers decide to exit the business, leaving their insureds with only 30 days of coverage and no likely replacement? This uncertainty is particularly unsettling in terrorism coverage, where the market is so thin and the circumstances of coverage can change so rapidly. We would certainly hope that carriers will offer more reasonable anti-cancellation agreements.

We have heard that both Lloyd's and AXIS Specialty are willing to write noncancelable (except for non-payment of premium) policies, but have been unable to confirm this. There have been a handful of noncancelable deals put together. They have involved additional charges.

Carriers assure us that there is no intent to trigger cancellation based on an increased threat, but we remain concerned that the contractual opportunity to cancel remains.

The one-year term of coverage is unsettling for insureds that may be entering into multi-year agreements that require coverage, such as construction projects. We understand that most policies are for a one-year term, but that a few have been written for construction projects that require three years of coverage. One carrier that will offer three-year terms for construction projects is AIG.

Cyber Attack Exclusions

Cyber attacks are treated differently among the three policy forms. This is coverage for attacks against an insured's information technology infrastructure. An example might be a determined "Denial of Service" attack by hackers, with intention of disrupting an insured's Web activities, or the insertion of a computer virus in the EDP system.

ACE excludes "Loss or damage by attacks by electronic means including computer hacking or the introduction of any form of computer virus."

The AIG form does not exclude such attacks, but since the only causes of loss covered are physical damage caused by fire, explosion or collision by aircraft or motor vehicle, cyber attacks would not be a covered cause of loss.

Lloyd's similarly requires physical loss or damage, and goes further by excluding "...attacks by electronic means..."

So it seems that none of the policies would cover cyber attacks, a very significant cause for worry.

There are special products that do cover cyber attacks (please refer to *The Betterley Report* CyberRisk Market Survey and Technology Providers E&O Market Survey). At this time, some CyberRisk policies exclude losses caused by cyber attacks, and we expect this to become pervasive. Insureds needing cyber terrorism coverage are well advised to keep a careful eye on that market's willingness to continue cyber terror coverage. AIG's E-business Risk Solutions unit has a specific product designed to cover Cyber Terror risks, but coverage is only available as an endorsement to their NetAdvantage suite. Coverage can be written in accordance with TRIA and as an optionally broader wording. We will report on this and similar products in our next report (June 2003).

Buybacks and Coverage Enhancements

Several types of terrorist acts are typically excluded under these policies, including radioactive, biological and chemical attacks. Some can be bought back, although radioactive is not one of them.

Chemical and biological attack exclusions can be bought back with the Lloyds form, and may be possible to buy back from the ACE and AIG policy, subject to sublimits of perhaps $25 million. As the market capacity increases and underwriters get more comfortable with the risk, perhaps higher limits will be available.

AIG Environmental provides a facility with substantial limits available for bio-terrorism risk.

PREDICTIONS AND CONCLUSION

We believe it is safe to predict that the interest of insurance companies currently offering terrorism coverage will continue, and that this interest will preserve—and perhaps grow—the market to a healthier level, with broader coverage and lower rates. Unfortunately, increasing capacity and lower rates will only result if attacks cease.

The creation and hoped-for improvement of TRIA can actually help the stand-alone market succeed in those areas where TRIA isn't the right coverage.

The market will need more capacity to cover all of the insureds we think will want coverage, and that will not be served well if shut out of the market because of accumulation constraints. This is one of the best results of TRIA.

Higher limits for individual locations are a must; terrorism targets by definition are almost always high-value properties, and they are likely to need higher limits than they can currently buy.

Terrorism coverage must become easier to buy in order for insureds to make the effort. This will happen; as more policies are written, insurance brokers will find it easier to arrange coverage, and Risk Managers will find it easier to justify them. TRIA coverage will work to meet the needs of many insureds, while the stand-alone market will be needed for more specific needs, especially domestic terrorism.

The current coverages are reasonably broad and effective, but individual insureds will need to be careful to make sure that the policies as written are appropriate for their risk.

Business interruption exposures are not well insured by the current terrorism policies, and these need to be made broader. In addition, Contingent Business Interruption coverage, for insureds not targets of attack, but who depend upon companies and other entities that may be targets, needs to be made available at reasonable rates. The difficulty in arranging blanket insurance will be a real challenge for Risk Managers.

But, looking back over the past year, between government-sponsored programs (TRIA) and the stand-alone market, there is a good selection of coverage available to most insureds that need it, even if they don't buy it.

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