TRIA and the Risk of Insurance Insolvencies

by Wayne J. Baliga

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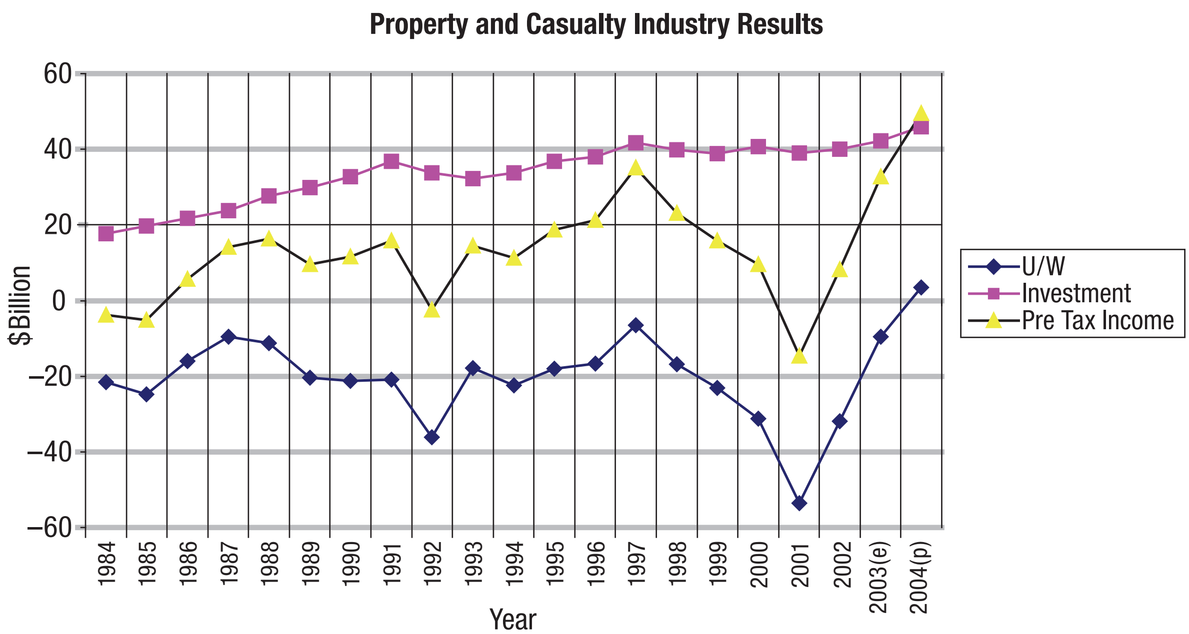
The Terrorism Risk Insurance Act of 2002 established a mechanism to shield insurance companies from the potential catastrophic impact of an insured loss unprecedented in size in the history of the United States. It also established a mechanism to ensure uninterrupted coverage for risks that might otherwise be excluded by insurers due to this potential catastrophic impact. Both of these goals are noble, and in practice as regards coverage availability, the Act has worked as advertised. However, as regards responding to a loss stemming from terrorism the TRIA has not been tested. When the Act is viewed in the context of the insurance marketplace in 2005, the question arises whether it will provide sufficient protection to prevent a wave of insurance company insolvencies in the event of an act of terrorism equal to or greater than the events of September 11, 2001.

I. The Current State of Property and Casualty Insurance

To understand the concern of large-scale insurance insolvencies in the event of a significant act of terrorism, one must first understand the current state of the insurance market. Over the past twenty years, property and casualty insurance has been for many insurers a money losing proposition. Property and casualty insurers have labored to achieve profitability on a consistent basis. However, as the chart below illustrates,



Source: A.M. Best

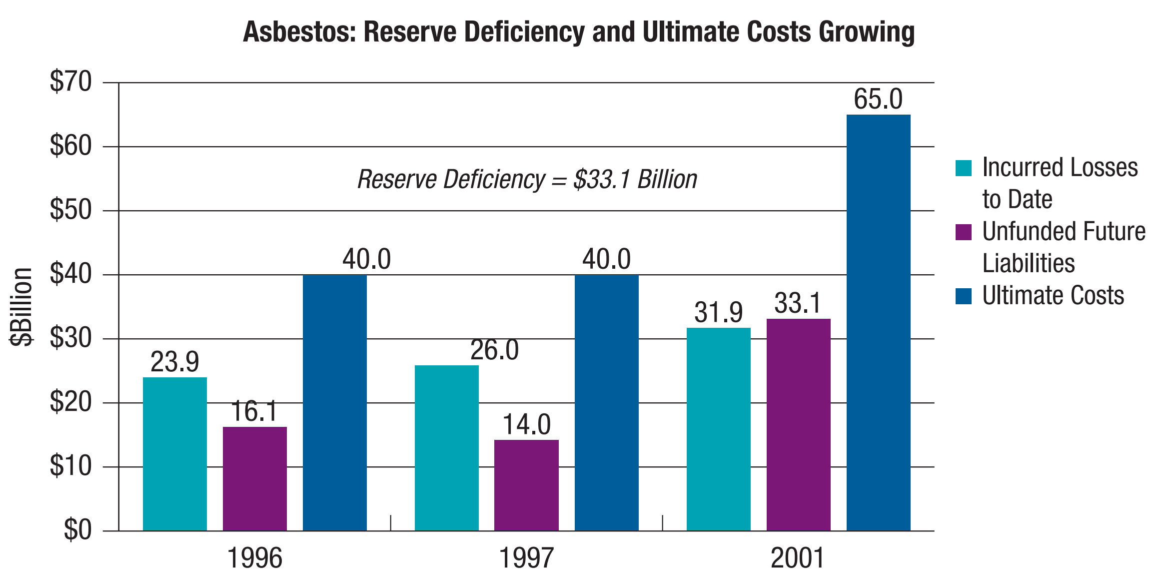
the P&C industry has not achieved underwriting profitability in the past twenty years. In four of those twenty years, the entire industry recorded a pre-tax loss. In the past ten years, over 200 insurance companies have become insolvent. Currently, A.M. Best rates 667 insurance companies A–. The significance of this statistic is that most insurance brokers, reinsurance brokers, and many insureds will not place business with a company that falls below an A– rating. Stated another way, close to 700 P&C insurers are currently one rating step from being no longer able to write new business.

This is not to imply that all insurers would face insolvency in case of a significant terrorism loss. Many A– insurers are well capitalized, and depending on reinsurance arrangements, business mix, capital and surplus, and other factors could absorb a significant terrorism loss. However, with 667 insurers in the A– category, even a 15 percent insolvency of these insurers would lead to insolvency for 100 insurance companies.

Complicating this issue is the potential unrecognized liabilities of P&C insurers. An October 4, 2004 report from A.M. Best noted that in the past three years insurers have taken special reserve charges for past claim liabilities of $47 billion. These large reserve charges have weakened capitalization of a number of insurance companies, often leading to ratings pressure and downgrades. Even with these reserve additions, A.M. Best believes reserves are still deficient by as much as $67 billion. This is equivalent to 19 percent of all policyholder surplus currently available to the P&C insurance industry. The Best report notes: "For casualty-oriented insurers, where carried reserves may be four or five times the size of policyholder surplus, a 25 percent reserve deficiency will render the company technically insolvent."

Further complicating this issue is the impact of the Sarbanes-Oxley Act on insurance company results. In the past, some companies delayed the posting of reserve development and, in a few extreme cases, concealed reserves to impact results. With the advent of the Sarbanes-Oxley Act of 2002 and the potential draconian penalties for officers and directors that engage in the conduct mentioned above, it is likely you will see acceleration of reserve reviews and recognition of liabilities. A.M. Best notes that: "A number of companies recently have completed or are in the process of completing ground-up A&E (asbestos and environmental) studies. Virtually all of the larger companies that completed these A&E studies increased their reserves for A&E losses, in some cases significantly. While market conditions generally have hardened for most lines of business, future reserve charges may severely impact the balance sheets and operating performance of some carriers. If unexpected, such charges would result in ratings pressure and downgrades."[1]

The A.M. Best analysis is supported by what occurred with asbestos reserves in the 1990s. After insurers indicated on several occasions in the early 1990s that asbestos reserves were adequate, the last few years of that decade witnessed continual increase in both incurred loss to date and unfunded future liabilities.



Source: A.M. Best

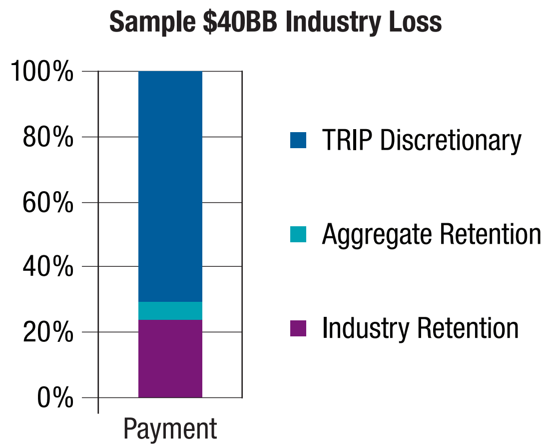
[1] A.M. Best Report, "P/C Industry Reserve Adequacy Still has a Long Way to Go (October 4, 2004).

II. The Impact of a Terrorism Loss

Against this backdrop of legacy issues for property and casualty insurance companies is the risk of a significant terrorism loss and the response of the terrorism insurance program to that loss. An illustration of a hypothetical terrorism loss illustrates the solvency concern. The hypothetical event includes the following events:

- A $40 billion "certified act of terrorism" in 2004 (this was the approximate size of the World Trade Center loss).
- 200 insurers each sustain $200 million of insured losses.
- These 200 insurers each wrote $300 million of direct earned premium in 2003.[2]

The hypothetical illustrates several significant points:



- The industry would pay approximately $12.5 billion of a terrorism loss.
- The United States government would pay $27.5 billion of a terrorism loss.
- The entire U.S. government portion is subject to potential discretionary recoupment by the government.
- The industry retention of any loss increases to $15 billion in 2005.

Now recall the statement earlier in this article by A.M. Best: "For casualty-oriented insurers, where carried reserves may be four or five times the size of policyholder surplus, a 25 percent reserve deficiency will render the company technically insolvent." The impact of a single terrorist event would be dramatic on a company's bottom line, and could trigger the type of event mentioned by Best. Best rates insurers on a financial size rating scale of 1–15 with 8 being the size midpoint. Category 8 includes insurers with surplus of $100 million to $250 million. If we take this group as representative of an average size insurance company, the impact of a terrorist event, even with current TRIA coverage, is dramatic.

Using the same hypothetical as above, but this time viewing the impact of a terrorism loss on an individual insurance company, the point is clearly illustrated. The hypothetical is as follows:

- $200 million insured loss in 2004
- $300 million of direct earned premium in 2004

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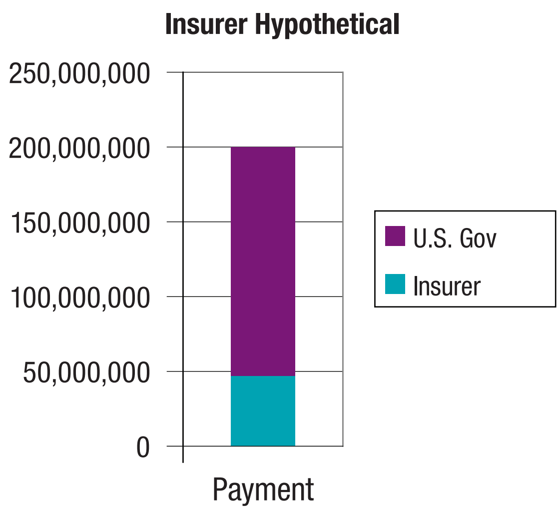
[2] Hypothetical presented by David J. Brummond, U.S. Treasury Legal Counsel, at the 2004 Smart and Associates Insurance Forum, October 12, 2004, Chicago, IL.

- $47 million retained loss by the insurer
- U.S. Government compensation of $153 million



In this scenario, an insurer with total capital and surplus of $100 million to $250 million would be called upon to pay a loss of $47 million (*i.e.*, 20 percent to 50 percent of total surplus). Whether an insurer could absorb this type of loss when combined with traditional loss development mentioned in this article is questionable. A loss of this size would compel A.M. Best and other rating agencies to review the insurer's financials, claim paying ability, etc., and could certainly trigger negative rating actions. Even an A– rated insurer that had the capital and surplus to pay this loss could suffer a rating downgrade to B++ and be forced into runoff due to its inability to be viewed as a secure insurer by brokers, reinsurers, and insureds. Therefore, it is fair to say that under the current regulatory scheme, a significant number of insurers could be impaired through either the inability to write new business or outright insolvency.

III. Conclusion

As stated at the outset, this White Paper is not meant to be an indictment of TRIA. To the contrary, the speed in which TRIA was enacted and its impact as a stabilizing factor for insurers is laudatory in all respects. However, with the renewal of TRIA pending, it is a good time to review whether the Act goes far enough in assuring that massive insurance industry disruption is not caused by another terrorist event. This article is not a call for a "government bail-out" of the property and casualty insurance industry. The industry has created many of its own problems as regards legacy loss development and inadequate pricing of its product in the 1980s and 1990s, and the industry should deal with these problems without governmental assistance.

Nevertheless, as the aftermath of 9/11 illustrated, insurance is a key component of economic growth and prosperity in the United States. The inability to obtain reasonably priced insurance with adequate coverage for likely exposures can stifle new construction, business expansion, product development, professional services, and a host of other critical undertakings that fuel economic growth. To that end, prevention of insurance company insolvencies due to an act of terrorism is a goal that benefits all parties—insurer and insured. Much more statistical study of insurance companies' current financial condition and the impact of a loss the size of WTC or larger needs to occur. This article merely suggests that this analysis should be done quickly and included as part of the debate over the renewal of TRIA and the size and scope of the renewed program.

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