Federal Terrorism Reinsurance (TRIA) Summary and Description*

What is TRIA?

In November 2002, the federal government enacted the Terrorism Risk Insurance Act (TRIA), which created a temporary federal reinsurance program to limit insurers' risk of financial loss from acts of terrorism. At the time, the attacks of September 11, 2001, had made insurers less willing to provide terrorism coverage because of uncertainty about the future risk of, and losses from, terrorist acts. Policymakers feared that a shortage of terrorism insurance could expose property owners to uninsured risk, retard commercial construction, and reduce economic activity in the short run. Indeed, anecdotal evidence suggested that some large construction projects had been canceled or delayed in part because of the lack of terrorism coverage. Many analysts expected that insurers would need some time to reassess the risk of terrorism, raise capital, and eventually reenter the market. But how long that would take was uncertain. The TRIA program was intended to fill the gap in the supply of terrorism insurance, at least until private insurers could recover.

Under TRIA, insurance companies are required to offer terrorism coverage. That coverage is subsidized by the federal government, which agrees to pay 90 percent of an insurer's losses, above a deductible, in the event of an attack by foreign terrorists. The insurer would have to pay the deductible and the other 10 percent of losses--up to a total limit for the program of $100 billion. The government would then be required to recoup some of its costs by assessing surcharges on commercial insurance policies sold after the terrorist attack occurred. Insurers are not charged any premiums for that federal reinsurance, which allows them to spread the risk of loss more widely, thus strengthening their ability to insure against catastrophes.

By increasing the availability of terrorism insurance at below-market rates, the TRIA program has led to a rise in the percentage of companies buying terrorism coverage, predominately in places thought to be at especially high risk of terrorist attacks.

The program is scheduled to expire on December 31, 2005. Some policymakers have called for an immediate extension of TRIA without major amendments. Others would allow the law to expire; still others would extend it with revisions. The Administration has deferred any decision about TRIA's future until at least the fall of 2005, when the Treasury is scheduled to deliver a report to the Congress on the reinsurance program. As part of that report, the Treasury is comprehensively surveying insurers and policyholders about their experiences under the program.

This Congressional Budget Office (CBO) analysis examines the effects of TRIA on insurance markets, the U.S. economy, and taxpayers. The conclusions that it reaches may be relevant to the choices facing policymakers.

- A primary consideration in the decision about TRIA's future is how long the elevated risk of terrorism is expected to last. If the increase in risk turns out to be temporary, TRIA may have succeeded in keeping property owners and insurance companies from overreacting to the attacks of September 11. By providing zero-premium coverage and not requiring policyholders to take actions to reduce their exposure to losses, TRIA effectively lessened incentives for property owners to make costly adjustments to a short-term threat.

PO BOX 899, PINE, COLORADO 80470 PHONE: 720.208.0844 FAX: 720.208.0845

- However, the growing belief that the terrorism threat is long-lived does not support a simple extension of TRIA. A persistent high-level risk of terrorism implies that the owners of assets at risk should adopt measures to reduce their losses--for example, by relocating some activities, retrofitting existing structures, investing in disaster-recovery information systems, and installing security systems. By subsidizing insurance rates, TRIA weakens owners' incentives to make those investments.

- The nation might adjust to a sustained high level of risk more quickly if the premiums charged for terrorism insurance reflected higher expected losses. That outcome could be achieved by letting the federal reinsurance program expire or by adding cost-based ("actuarially fair") premiums to the program.

- Alternatives to terrorism insurance also would be likely to develop more quickly if premiums were actuarially fair. That is, the expiration of TRIA or the addition of cost-based premiums could stimulate the development of mutual reinsurance pools and of capital instruments such as catastrophe bonds. Another, less costly alternative to traditional insurance is for owners of the largest assets at risk (and their creditors) to protect themselves by diversifying their holdings among many different properties and locations.

- Letting the TRIA program end would not increase the overall cost to the nation of the risk of terrorism. In fact, losses from terrorist attacks could decline if the resulting higher premiums encouraged firms to adopt measures to reduce losses.

- TRIA's expiration would, however, change who bore the ultimate burden of that overall cost. Under TRIA, most of the cost of the catastrophic risk of terrorism is initially borne by taxpayers. (Future policyholders would reimburse the government for at least some realized losses after the fact, but those surcharges would not compensate taxpayers for bearing the uncertainty and risk of the insurance.) If the TRIA program ended as scheduled, more of the future costs of terrorism risk would be borne by the owners of assets at risk.

- If TRIA expired, the availability and price of terrorism coverage would depend in part on the willingness of private-sector reinsurers to assume the catastrophic risk. There are indications that private reinsurers would fill much of the gap in supply left by TRIA's expiration, but that outcome is not certain.

- If TRIA expired, reinsurers would most likely continue their previous practice of not covering losses from nuclear, biological, chemical, and radiological attacks. That exclusion would be important mainly for the workers' compensation market, because primary insurers that offer workers' compensation policies are required to cover loses from all causes. If such insurers were unable to diversify that catastrophic risk through reinsurance, rates for workers' compensation policies could rise substantially, at least in the near term.

- In the event that the TRIA program ended and an unexpectedly large terrorist attack occurred, insurance markets would probably be disrupted again, and coverage could be unavailable for some high-risk properties.

In sum, as the Congress considers whether to extend TRIA (and in what form), it is useful to consider what has changed in the two years since the law was enacted. The most significant development seems to be a growing sense that the terrorism threat to the United States will continue for the foreseeable future. That development suggests that the economy, especially the stock of physical capital, needs to be responsive to the prospective losses from terrorist attacks. For example, new construction might be designed, located, and built to withstand such attacks. Existing structures might need to be retrofitted with safety features. Those needs argue against extending the TRIA program in its current form, which subsidizes insurance and dampens incentives for mitigation activities.

The macroeconomic costs of scaling back the federal subsidy for terrorism insurance are likely to be small. One reason is that the capacity of insurance companies to provide terrorism coverage has improved recently. Another reason is that TRIA does not lower the costs of terrorist attacks but rather partially shifts those costs from property owners to taxpayers. As noted above, total costs might be lower without TRIA. However, the gains in economic efficiency from allowing TRIA to expire could require a significant trade-off: without the TRIA program, an especially large loss from a terrorist attack would be likely to produce another episode of scarce coverage, rising prices, and uninsured assets.

*Reprinted with the permission of the U.S. Congressional Budget Office 2005

Additional information can be obtained by visiting the U.S. Congressional Budget Office Website: www.cbo.gov