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Report to the Chairman, Committee on Financial Services, House of Representatives

April 2004

TERRORISM INSURANCE

Implementation of the Terrorism Risk Insurance Act of 2002

GAO

Accountability ★ Integrity ★ Reliability

GAO-04-307

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GAO Accountability • Integrity • Reliability

Highlights

Highlights of GAO-04-307, a report to the Chairman, Committee on Financial Services, House of Representatives

Why GAO Did This Study

After the terrorist attacks of September 11, 2001, insurance coverage for terrorism largely disappeared. Congress passed the Terrorism Risk Insurance Act (TRIA) in 2002 to help commercial property-casualty policyholders obtain terrorism insurance and give the insurance industry time to develop mechanisms to provide such insurance after the act expires on December 31, 2005. Under TRIA, the Department of Treasury caps insurer liability and would process claims and reimburse insurers for a large share of losses from terrorist acts that Treasury certified as meeting certain criteria. As Treasury and industry participants have operated under TRIA for more than a year, GAO was asked to describe (1) their progress in implementing the act and (2) changes in the terrorism insurance market under TRIA.

What GAO Recommends

GAO recommends that the Secretary of the Treasury, as part of Treasury's study of the effectiveness of TRIA and after consultation with insurance industry participants, identify for Congress alternatives that may exist for expanding the availability and affordability of terrorism insurance after TRIA expires. These alternatives could assist Congress during its deliberations about terrorism insurance.

www.gao.gov/cgi-bin/getrpt?GAO-04-307.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov.

What GAO Found

Treasury and industry participants have made significant progress in implementing TRIA during its first year, but Treasury has important work to complete in order to comply with its responsibilities under the act. For example, Treasury has issued regulations to define program requirements, created and fully staffed the Terrorism Risk Insurance Program office, and begun data collection efforts in support of mandated studies. Insurers also have adjusted their operations and policies to comply with TRIA. However, insurers have expressed concerns that Treasury has not yet decided whether to extend through 2005 the requirement that insurers offer terrorism coverage on terms that do not differ materially from other coverage. Although the act gives Treasury until September 1, 2004, to decide this issue, a more timely decision is needed to avoid hindering underwriting and pricing decisions for policies that are issued or renewed through 2005. In addition, Treasury has not fully established a claims processing and payment structure. Insurers are concerned that a delayed payment of claims by Treasury, whether because of the length of time taken to certify that an act of terrorism met the requirements for federal reimbursement or from inadequate claims processing capability, might seriously impact insurer cash flows or, in certain circumstances, insurer solvency.

It appears that Congress's first objective in creating TRIA—to ensure that business activity did not materially suffer from a lack of available terrorism insurance—has been largely achieved. Since TRIA was enacted in November 2002, terrorism insurance has been generally available to businesses. But most commercial policyholders are not buying the coverage. According to insurance industry experts, purchases have been higher in areas considered to be at high risk of another terrorist attack. However, many policyholders with businesses or properties not located in perceived high-risk locations are not buying coverage because they view any price for terrorism insurance as high relative to their perceived risk exposure. Further, those who have bought terrorism insurance remain exposed to significant perils. Insurers have broadened long-standing policy exclusions of nuclear, biological, and chemical events. Congress's second objective—to give private industry a transitional period during which it could begin pricing terrorism insurance and develop ways to cover losses after TRIA expired—has not yet been achieved. Industry sources indicated that under TRIA, insurance market participants have made no progress to date toward the development of reliable methods for pricing terrorism risks and made little movement toward developing any mechanism that would enable insurers to provide terrorism insurance to businesses without government involvement.

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Abbreviations

GAO	U.S. General Accounting Office
NAIC	National Association of Insurance Commissioners
NBC	nuclear, biological, and chemical
OMB	Office of Management and Budget
RFP	Request for Proposal
SFP	standard fire policy
TRIA	Terrorism Risk Insurance Act of 2002
TRIP	Terrorism Risk Insurance Program

United States General Accounting Office
Washington, D.C. 20548

April 23, 2004

The Honorable Michael Oxley
Chairman, Committee on Financial Services
House of Representatives

Dear Mr. Chairman:

The terrorist attacks of September 11, 2001, drastically changed the way insurers viewed the risk of terrorism. An industry that had considered the risk of terrorism so low that it did not identify or price terrorism risk separate from property and casualty coverage will pay approximately $40 billion for losses arising from September 11, according to industry experts. In the aftermath, we reported that insurance coverage was disappearing for terrorist events, particularly for large businesses and those perceived to be at some risk.[1] As contracts between reinsurers and insurers came up for renewal, reinsurers excluded terrorism from coverage.[2] Without reinsurance, insurers retained greater levels of risks than they could responsibly carry, and their reaction was to exclude these risks from commercial policies as they were renewed.

In light of concerns that the lack of terrorism insurance could have significant effects on the economy or that, in the event of another terrorist attack, the economic costs would fall directly on the victims and the government, Congress passed the Terrorism Risk Insurance Act of 2002 (TRIA), which took effect on November 26, 2002.[3] Under TRIA, the Department of the Treasury (Treasury) would reimburse insurers for a large share of the losses associated with certain acts of foreign terrorism that occur during the 3-year term of the act. The purpose of TRIA is twofold: to make terrorism insurance widely available and affordable to

[1]U.S. General Accounting Office, *Terrorism Insurance: Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities*, GAO-02-472T (Washington, D.C.: Feb. 27, 2002).

[2]Reinsurance is a mechanism that insurance companies routinely use to spread risk associated with insurance policies. Simply put, it is insurance for insurance companies. Reinsurance is a normal business practice that satisfies a number of needs in the insurance marketplace, including the need to expand capacity and obtain protection against potential catastrophes.

[3]When the President signed TRIA into law on November 26, 2002, its provisions took effect immediately.

commercial policyholders for the duration of the act and to provide a transitional period during which insurance market participants could find ways to price terrorism insurance and develop market-driven resources and mechanisms that would offer terrorism insurance after TRIA expires on December 31, 2005.

TRIA requires that all insurers selling commercial lines of property and casualty insurance "make available" coverage for certain terrorist events in the first 2 years of the program. TRIA defines "make available" to mean that the coverage must be offered for insured losses arising from terrorist events and that coverage not differ materially from the terms, amounts, and limitations applicable to coverage for losses arising from other types of events. However, TRIA gives Treasury the option of determining whether the "make available" requirement should be extended through 2005, the third year of the act, and gives the agency until September 1, 2004, to do so. Also, not all acts of terrorism will trigger reimbursements under TRIA: the Secretary of the Treasury must "certify" that an act of terrorism meets the criteria specified in TRIA.[4] For example, "an individual or individuals acting on behalf of any foreign person or foreign interest" must commit the act. After an event is certified, TRIA authorizes Treasury to reimburse insurers for most of the insured losses, after they have paid specified deductible amounts. Moreover, TRIA authorizes Treasury to administer the Terrorism Risk Insurance Program (TRIP) office, through which Treasury will administer TRIA provisions and would pay claims. TRIA also mandates various studies and data collection efforts and contains provisions affecting the National Association of Insurance Commissioners (NAIC).[5]

Treasury and industry participants have operated under TRIA for more than a year. Consistent with your request, in this report we describe (1) the progress made by Treasury and insurance industry participants in implementing TRIA provisions and (2) changes in the market for terrorism insurance coverage under TRIA.

To address these objectives, we reviewed and analyzed Treasury's final and proposed regulations in the *Federal Register*, public comments that were

[4]Section 102 of TRIA provides that the Secretary of the Treasury, in concurrence with the Secretary of State and the Attorney General of the United States, shall determine whether an event should be certified as an act of terrorism, based on certain criteria.

[5]NAIC is a voluntary organization of the chief insurance regulatory officials of the 50 states, the District of Columbia, and four U.S. territories.

submitted about the regulations, relevant information concerning state legislation, and publicly available and proprietary industry data and studies on the terrorism insurance market. We interviewed officials at Treasury, NAIC, and state insurance regulators from six states with high insurance sales volumes. We also interviewed representatives of insurance companies, reinsurance companies, brokers for insurance and reinsurance companies, industry associations, property owners and developers, and insurance filing services and credit rating agencies.[6] In our discussions with these organizations, we endeavored to gain an understanding of their experience in implementing TRIA requirements, obtain their views on the effects of TRIA on the terrorism insurance market, and identify developments within the industry to address terrorism risks after TRIA expires.

We conducted our work in Chicago, New York City, and Washington, D.C., from January 2003 through April 2004 in accordance with generally accepted government auditing standards.

Results in Brief

Treasury and industry participants have made significant progress in implementing TRIA to date, but Treasury has important actions to complete in order to comply with its responsibilities under TRIA. Between November 2002 and December 2003, Treasury issued implementing regulations, or final rules, on issues such as definitions of basic terms used in TRIA and written disclosure to policyholders about TRIA requirements, limits of coverage, and prices. During that same period, Treasury issued a proposed rule on basic claims procedures. According to Treasury officials, Treasury also fully staffed the TRIP office by September 2003, decided not to extend TRIA to group life insurance lines based on the results of a TRIA-mandated study, and began mandated studies and data collection efforts. However, Treasury has not yet decided whether to extend the requirement to policies issued or renewed in 2005 that insurers “make available” terrorism insurance on terms not differing materially from other coverage. In addition, it has not fully established a claims processing and payment structure. NAIC, in its advisory role, has effectively assisted Treasury in drafting guidance and regulations, and insurance companies generally have made policy and operational changes—including pricing decisions, policy language revisions, and policyholder notifications—to

[6]Filing services perform many services for insurance companies, including submitting to state insurance regulators the documents required to sell a line of insurance.

comply with TRIA. However, insurers have expressed concerns about some work Treasury has not yet completed and the time frames allotted in TRIA that drive its work and responsibilities. For example, insurers noted that if Treasury waited until the TRIA deadline, September 1 of this year, to decide whether insurers would have to make terrorism insurance available through 2005, the decision would come too late for them to make appropriate decisions for business planning for the third year of TRIA. Moreover, a delayed payment of claims by Treasury, whether because of the length of time taken to certify that an act of terrorism met the requirements for federal reimbursement or from inadequate claims processing capability, might seriously impact insurer cash flows or, in certain circumstances, solvency.

Under TRIA, insurers and, to a limited extent, reinsurers have made terrorism insurance available, but most commercial policyholders are not buying the coverage and those that do remain exposed to significant risks. According to real estate and risk management experts, TRIA primarily has benefited high-risk policyholders, such as owners and developers of large commercial properties located in major urban centers and geographic locations perceived at greater risk for terrorism. Limited, but consistent results from industry surveys suggest between 10 and 30 percent of commercial policyholders are purchasing terrorism insurance. However, according to insurance industry experts, many policyholders with businesses or properties not located near major urban centers or in perceived high-risk locations are not buying terrorism insurance because they perceive themselves at low risk for terrorism and thus view any price for terrorism insurance as high relative to their risk exposure. Some industry experts are concerned that adverse selection—where those most at risk from terrorism are generally the only ones buying terrorism insurance—may be occurring. The potential negative effects of low take-up, or purchase rates, in combination with adverse selection would become evident only in the aftermath of a terrorist attack and include more difficult economic recovery for businesses without terrorism coverage and potentially significant financial problems for insurers. Moreover, policyholders with terrorism insurance may still not be insured for certain significant perils resulting from terrorist events, even if the events were to be certified. These perils include losses resulting from nuclear, biological, and chemical (NBC) agents, radioactive contamination, and in a growing number of states, fire following terrorist events. The insurance industry has historically applied certain of these limitations and exclusions. In the aftermath of September 11, state legislatures have permitted their expansion and they remain in place. Finally, under TRIA insurance market participants have not yet developed a reliable method for pricing terrorism risks and made little movement toward any mechanism that would enable insurers to provide terrorism insurance to businesses without government involvement.

The Assistant Secretary for Financial Institutions, Department of the Treasury, provided written comments on a draft of this report. Treasury generally believed the report was a thorough and well-balanced discussion of the impact and implementation of TRIA. Treasury's comments also explained how it prioritized its work at the inception of the program to help the insurance industry implement TRIA's requirements and expanded upon the details of its contingency plans for a terrorist event occurring before all regulations and structures were in place and contractors hired. Treasury's comments are reprinted in appendix I.

Background

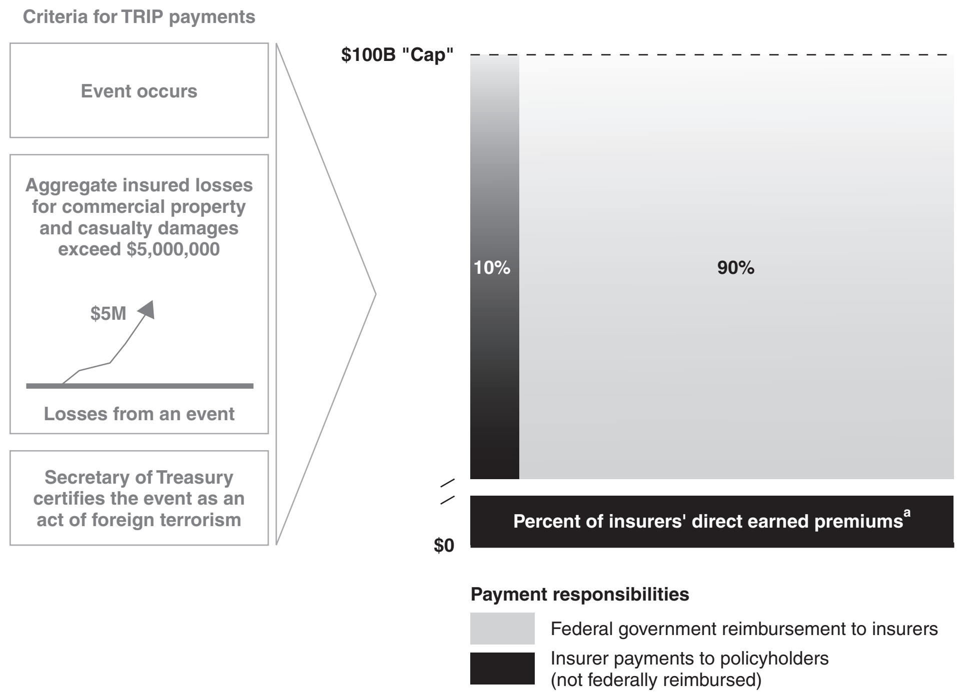
Under TRIA, Treasury is responsible for reimbursing insurers for a portion of terrorism losses under certain conditions. Payments are triggered when (1) the Secretary of the Treasury certifies that terrorists acting on behalf of foreign interests have carried out an act of terrorism and (2) aggregate insured losses for commercial property and casualty damages exceed \$5,000,000 for a single event.[7] TRIA specifies that an insurer is responsible (i.e., will not be reimbursed) for the first dollars of its insured losses—its deductible amount. TRIA sets the deductible amount for each insurer equal to a percentage of its direct earned premiums for the previous year.[8] Beyond the deductible, insurers also are responsible for paying a percentage of insured losses. Specifically, TRIA structures pay-out provisions so that the federal government shares the payment of insured losses with insurers at a 9:1 ratio—the federal government pays 90 percent of insured losses and insurers pay 10 percent—until aggregate insured losses from all insurers reach \$100 billion in a calendar year (see fig. 1).

[7]Aggregate insured losses are the sum of insured property and casualty losses from all commercial policyholders as a result of a certified act of terrorism.

[8]Section 102(4) of TRIA defines direct earned premiums as "a direct earned premium for property and casualty insurance issued by any insurer for insurance against losses…." Treasury provided further clarification that direct earned premiums are "earned as reported to the NAIC in the Annual Statement in column 2 of Exhibit of Premiums and Losses (commonly known as Statutory Page 14)" and cover all risks, not only for risks from terrorism. The percentage of the direct earned premium allowed as an insurer deductible varies over the program years: 7 percent in 2003, 10 percent in 2004, and 15 percent in 2005.

Thus, under TRIA's formula for sharing losses, insurers are reimbursed for portions of the claims they have paid to policyholders. Furthermore, TRIA then releases insurers who have paid their deductibles from any further liability for losses that exceed aggregate insured losses of $100 billion in any one year. Congress is charged with determining how losses in excess of $100 billion will be paid.[9]

Figure 1: Prerequisites and Limits of Coverage under TRIA



Source: GAO analysis of Terrorism Risk Insurance Act of 2002.

[a]The percentage of direct earned premiums increases each year: 7 percent in 2003, 10 percent in 2004, and 15 percent in 2005.

TRIA also contains provisions and a formula requiring Treasury to recoup part of the federal share if the aggregate sum of all insurers' deductibles and 10 percent share is less than the amount prescribed in the act—the "insurance marketplace aggregate retention amount." TRIA also gives the Secretary of the Treasury discretion to recoup more of the federal payment

[9]Sections 103(e)(2)(A)(i-ii) and 103(e)(3) of TRIA.

if deemed appropriate.[10] Commercial property-casualty policyholders would pay for the recoupment through a surcharge on premiums for all the property-casualty policies in force after Treasury established the surcharge amount; the insurers would collect the surcharge. TRIA limits the surcharge to a maximum of 3 percent of annual premiums, to be assessed for as many years as necessary to recoup the mandatory amount. TRIA also gives the Secretary of the Treasury discretion to reduce the annual surcharge in consideration of various factors such as the economic impact on urban centers. However, if Treasury makes such adjustments, it has to extend the surcharges for additional years to collect the remainder of the recoupment.

Treasury is funding TRIP operations with "no-year money" under a TRIA provision that gives Treasury authority to utilize funds necessary to set up and run the program.[11] The TRIP office had a budget of $8.97 million for fiscal year 2003 (of which TRIP spent $4 million), $9 million for fiscal year 2004, and a projected budget of $10.56 million for fiscal year 2005—a total of $28.53 million over 3 years. The funding levels incorporate the estimated costs of running a claims-processing operation in the aftermath of a terrorist event: $5 million in fiscal years 2003 and 2004 and $6.5 million in fiscal year 2005, representing about 55 to 60 percent of the budget for each fiscal year. If no certified terrorist event occurred, the claims-processing function would be maintained at a standby level, reducing the projected costs to $1.2 million annually, or about 23 percent of the office's budget in each fiscal year. Any funds ultimately used to pay the federal share after a certified terrorist event would be in addition to these budgeted amounts.

[10]According to Treasury officials, the formula for the mandatory portion of the recoupment is intended to ensure that the insurance industry is financially responsible for a prescribed level of the first dollars of losses. The prescribed loss levels are as follows: $10 billion in 2003, $12.5 billion in 2004, and $15 billion in 2005. Therefore, if the sum of insurers' aggregate payments for deductibles and the 10 percent share—the amounts paid by industry—is less than the level prescribed for that year, then a recoupment would be required to collect the difference. On the other hand, if the amounts paid by industry exceed the prescribed level, then a recoupment would not be needed.

[11]"No-year money" is budget authority that remains available for obligation until expended, usually until the objectives for which the authority was made available are attained.

Treasury and Industry Participants Have Made Progress in Implementing TRIA, but Treasury Has Not Yet Achieved Key Goals

More than a year after TRIA's enactment, Treasury and insurance industry participants have made progress in implementing and complying with its provisions, but Treasury has yet to fully implement the 3-year program. Treasury has issued regulations (final rules) to guide insurance market participants, fully staffed the TRIP office, and started collecting data and performing studies mandated by TRIA. However, Treasury has yet to make the claims payment function operational and decide whether to extend the "make available" requirement through 2005. In its advisory role, NAIC has effectively assisted Treasury in drafting guidance and regulations and planning mandated studies. Insurance companies are also generally complying with TRIA requirements by making changes to their operations, such as revising premiums and policy terms. However, insurers do not yet know whether they will be required to "make available" terrorism insurance for policies issued or renewed in 2005. Additionally, they have voiced concerns about the time Treasury might take to certify an act of terrorism as eligible for reimbursement under TRIA and process and pay claims after an act was certified.

Treasury Has Issued Some Regulations, Staffed the TRIP Office, and Begun Studies and Data Collection

To implement TRIA and make TRIP functional, Treasury has taken numerous regulatory and administrative actions, which encompass rulemaking, creating a new program office, and collecting and analyzing data. To date, Treasury has issued three final rules and one proposed rule, which provide uniform definitions of TRIA terms, explain disclosure requirements, determine which insurers are subject to TRIA, and establish a basic claims-paying process. Treasury has also created and staffed the TRIP office, which will oversee claims processing, payment, and auditing. Finally, Treasury has completed a TRIA-mandated assessment and is working on other reporting and data collection mandates.

To Be Ready for Possible Terrorist Events, Treasury Quickly Issued Interim Guidance and Interim Final Rules

After TRIA became effective, Treasury officials said they moved quickly to provide immediate guidance to the insurance industry on time-sensitive requirements. Because the process required to issue final regulations would take a few months, Treasury published four sets of interim guidance in the *Federal Register* between December 2002 and March 2003. The first three sets of interim guidance were in a question-and-answer format to provide quick answers to specific questions, and the fourth interim guidance contained regulatory language. The purpose of the interim guidance was to help insurance companies and other entities determine if they were subject to TRIA and to help insurers quickly modify forms and policies and adjust operations by providing definitions and program parameters. Interim guidance in December 2002 covered requirements for disclosure (e.g., notification to policyholders), the “make available” provision, and which lines of property-casualty insurance were subject to TRIA. For example, the guidance explained that under TRIA insurers are required to send notices to their policyholders containing information about the availability and cost of terrorism insurance and the 90 percent federal share. Subsequent guidance provided information on topics such as how certain insurers should allocate direct earned premiums (which are used to determine what their deductibles would be), alternative methods for complying with TRIA's disclosure requirement, and the application of TRIA to non-U.S. insurers. The interim guidance remained in force while Treasury drafted final rules.

In addition to interim guidance, Treasury also published two interim final rules and a proposed rule. The first interim final rule laid the foundation of the program and key definitions for terms used in TRIA. The second interim final rule covered disclosure and “make available” requirements. The proposed rule addressed “state residual market insurance entities” and “state workers compensation funds”—two types of state-created entities that will be discussed below. The interim final rules had the force of law until they were superseded by final rules. As a result, Treasury officials stated, had a terrorist act occurred before final rules took effect, a regulatory structure would have been in place to allow a faster response than would otherwise have been possible.

Treasury Also Has Published Final Rules

As of March 1, 2004, Treasury's interim guidance, interim final rules, and proposed rule had been superseded by three final rules. The first final rule was published in the *Federal Register* on July 11, 2003, and addressed basic definitions of words used in TRIA, such as “insurer” and “property and casualty insurance.”[12] Treasury officials said they completed this regulation first to provide a foundation for subsequent regulations, which would use these terms frequently. Although TRIA provided definitions for these terms, TRIA also specified that state insurance regulations be preserved where possible. According to Treasury officials, Treasury thus devoted much effort to ensure that TRIA's definitions of property-casualty insurance terms would be consistently applied across jurisdictions—a difficult task because Treasury did not have existing uniform or consistent

[12]The first final rule received a technical revision, dealing with the definition of direct earned premium. Treasury published this technical revision in August 2003 in volume 68 of the *Federal Register*, page 48280.

definitions of the terms used in TRIA. For example, the term "commercial property-casualty insurance" includes slightly different lines of insurance in each state's definition. Treasury decided to use information that insurers submitted in annual statements to NAIC as the basis for defining property-casualty insurance.[13]

On October 17, 2003, Treasury issued its second final rule on disclosure and "make available" requirements for insurers (see fig. 2). These time-sensitive requirements, which insurers had to meet to be eligible to receive federal reimbursement for terrorist losses, had originally been spelled out in the interim final rule. Among other things, the rule stated that insurers that had used NAIC's model disclosure forms to notify their policyholders about TRIA and terrorism insurance premiums had complied with TRIA disclosure requirements. The rule also clarified that insurers did not have to make available coverage for certain risks if the insurer's state regulator permitted the exclusion of those risks and the insurer had made the same exclusion from coverage on all other types of policies. For example, Treasury's explanations in the rule specifically used policy exclusions for NBC events to illustrate this point. (We discuss these exclusions in more detail later in this report.)

The third final rule, also issued on October 17, 2003, instructed two kinds of insurers that are typically created by state governments—"state residual market insurance entities" and "state workers' compensation funds"—on how TRIA provisions apply to them (see fig. 2). States establish residual market insurance entities to assume risks that are generally unacceptable to the normal insurance market, and state workers' compensation funds are state funds established to provide workers injured on the job with guaranteed benefits. The other insurance companies operating in the state usually fund these state-created entities. The rule explained how a state residual market insurance entity and its insurance company members should allocate direct earned premiums among themselves for the purposes of calculating deductibles under TRIA, because the size of the TRIA deductible is determined by the size of a company's direct earned premium. Treasury crafted provisions specific to state residual market insurance entities because, depending on the particular state law, both the premiums and the profits and losses of these entities may be shared with

[13]As previously noted, the information to define "property-casualty insurance" comes from the exhibit of premiums and losses found in the annual statement that insurers submit to NAIC.

their insurance company members. Absent these specific provisions, in those cases where premiums were shared the premiums would be double counted, resulting in an unfair increase in the deductible of the insurance company. The rule also applied TRIA's disclosure provisions to both types of state-created entities.

Treasury also issued a proposed rule on December 1, 2003, which would establish the first stages of a basic claims-paying process (see fig. 2). According to Treasury officials, this proposed regulation sets up an initial framework for the claims process, including instructions to insurers to notify Treasury when they have reached 50 percent of their deductible. This notification provides Treasury with advance notice of possible impending claims. The proposed rule also contains, among other things, requirements for insurers to receive federal reimbursements and provides associated recordkeeping requirements. Treasury intends to supplement the proposed rule with additional, separate guidance that will provide detailed operating procedures for claims filing and processing. According to the officials, Treasury took this phased approach to get the basic rules out to insurers in case a terrorist event occurred.

Finally, a Treasury official said that Treasury staff drafted another rule, which is currently under review by the Office of Management and Budget (OMB). The draft, which will be published and available for public comment as a proposed rule after OMB approves it, addresses litigation management (see fig. 2). The draft proposed rule would apply a TRIA provision that establishes that suits arising from certified terrorist events are federal causes of action and establishes litigation management procedures.

Figure 2: Regulations and Procedures Necessary to Implement TRIA

TRIA provisions		Status of Treasury regulatory and administrative actions
Sec. 103(b)(2)[b]	Provide criteria on disclosure notifications to policyholders.	Final rule took effect on October 17, 2003.
Sec. 103(c)[b]	Develop regulations to establish criteria that would fulfill TRIA's "make available" requirement.	Final rule took effect on October 17, 2003.
Sec. 103(d)(1)[a]	Extend TRIA to state residual market insurance entities and state workers' compensation funds.	Final rule took effect on October 17, 2003.
Sec. 103(e)(7) and (8)[b]	Develop a process to determine the recoupment amount. Develop a process to determine the surcharge on policyholder premiums and the length of time for which it will be in effect.	No action to date.
Sec. 103(f)[a]	Apply—at Treasury's discretion—TRIA to offshore captive insurers and other types of self-insurers.	No action to date.
Sec. 104(a)(1)[b]	Develop procedures for claims investigation and claims audit processes.	Work ongoing but not completed.
Sec. 104(a)(2)[a]	Develop regulations to effectively administer and implement TRIA.	Ongoing. Some final rules completed.[d]
Sec. 104(b)[a]	Develop—at Treasury's discretion—interim final rules on filing and certifying claims, paying for estimated or actual insured losses, and adjusting for over- and underpayment of estimated insured losses (final netting).	Treasury published a proposed rule on December 1, 2003.[e]
Sec. 104 (e)[b]	Develop procedures to assess civil monetary penalties.	No action to date.
Sec. 105 (c)[b]	Develop regulations on disclosure notice requirements for reinstating terrorism exclusions on in-force policies.	Final rule took effect on October 17, 2003.
Sec. 107[b]	Describes litigation management.	Draft is at OMB for review and has not yet been published.
Sec. 108(b)[c]	Develop procedures for claims settlement and recoupment after TRIA expires.	No action to date.

(white)	Final rule effective
(light gray)	Proposed rule
(gray)	Under development
(black)	No action

Sources: TRIA (data); GAO (analysis).

[a]TRIA sections that establish specific mandates or provide authority for Treasury to develop regulations.

[b]TRIA sections for which Treasury has said that it would issue regulations.

[c]TRIA sections that by inference require Treasury to take regulatory or administrative actions.

[d]For example, Treasury published a final rule on July 11, 2003 that provided basic definitions.

[e]The proposed rule details basic procedures insurers would follow to file a claim for reimbursement of the 90 percent federal share. Treasury also plans to issue more detailed guidance that, for example, would provide standardized forms and explain the method of payment.

Writing the regulations has been a lengthy and difficult process, not only because of the multiple procedural review requirements of federal rulemaking, but also because TRIA established that state insurance regulations should be preserved where possible.[14] For example, as previously discussed, creating definitions in accord with the statutory definitions of more than 50 jurisdictions (the states, District of Columbia, Puerto Rico, and U.S. territories) required extensive discussions among the state regulators, which in turn required additional time to plan and execute.

Treasury Has Fully Staffed the TRIP Office

In addition to developing regulations to implement TRIA, Treasury fully staffed the TRIP office by September 2003. The TRIP office develops and oversees the operational aspects of TRIA, which encompass claims management—processing, review, and payment—and auditing functions. The TRIP staff consists of an executive director, a senior advisor, two attorneys, two policy analysts, and two administrative staff. Since becoming operational, TRIP staff have drafted regulations and performed other tasks necessary to make the program functional. For example, staff reviewed and incorporated appropriate public comments to proposed regulations and visited reinsurers to learn more about paying claims submitted by insurers as a prelude to developing criteria for claims payment and processing. Staff also will be issuing contracts for vendors to supply these claims services. (We discuss the claims processing function in more detail later in this report.) Additionally, TRIP staff have ongoing work such as issuing interpretive letters in response to questions submitted by the public and participating in conferences across the United States to inform regulators, industry participants, and the public about TRIA provisions.

Treasury Has Begun Mandated Data Collection and Analysis

Treasury has completed one TRIA mandate for data collection and a study and has begun work on others. Specifically, TRIA mandated that Treasury provide information to Congress in four areas: (1) the effects of terrorism on the availability of group life insurance, (2) the effects of terrorism on the

[14]The procedural requirements for federal rulemaking include reviewing proposed regulations prior to publication in the *Federal Register*. Pursuant to the "Regulatory Planning and Review" rule (Executive Order 12866), the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), and the Paperwork Reduction Act (44 U.S.C. 3501 et seq.), respectively: (1) all regulatory actions that are considered significant should be reviewed by OMB; (2) the economic impact of the proposed regulation on small entities should be assessed; and (3) the recordkeeping requirements of the proposed regulation should be assessed. In addition, Section 101(b)(2) of TRIA provides that state insurance regulations should be preserved.

availability of life and other lines of insurance, (3) annual data on premium rates, and (4) the effectiveness of TRIA (see table 1). Treasury's Office of Economic Policy is responsible for organizing and analyzing information associated with the mandated studies and assessments.

Table 1: TRIA-Mandated Studies and Data Collection

TRIA citation	Description of study or data-collection effort
Sec. 103(h)(1)	• Determine whether adequate and affordable catastrophe reinsurance for terrorist events is available to life insurers that issue group life insurance. • Determine the extent to which the threat of terrorism is reducing the availability of group life insurance.
Sec. 103(i)	• Study the potential effects of terrorism on the availability of life insurance and other lines of insurance, including personal lines. • Report results to Congress no later than 9 months from enactment of TRIA.
Sec. 104(f)	• Annually collect information on terrorism insurance risk premium rates for previous year. • Make results available upon request of Congress.
Sec. 108(d)(1)	• Assess the effectiveness of TRIA. • Project the capacity of the property-casualty insurance industry to offer terrorism coverage after TRIA expires. • Project the availability and affordability of terrorism insurance for different types of policyholders, including railroads, trucking, and public transit. • Report results to Congress no later than June 30, 2005.

Sources: TRIA (data); GAO (analysis).

Pursuant to TRIA section 103(h)(1), Treasury completed an assessment of the availability of group life insurance and reinsurance for insurers issuing group life policies. Treasury concluded that the terrorism threat had not reduced the availability of group life insurance, but had reduced the availability of reinsurance, finding a general lack of catastrophic reinsurance for group life coverage. After completing the assessment, Treasury issued a press release in August 2003 stating that it had decided not to make group life insurance subject to TRIA because it found that insurers had continued to provide group life coverage. According to life insurance experts, life insurers have done so to maintain customer relations that would be difficult to reestablish if the coverage were discontinued. Additionally, life insurance experts noted that business from other lines of insurance would be lost if insurers were to discontinue group life, which is typically sold as part of a package with disability and medical coverage.

Treasury has not yet completed a mandated study on the effects of terrorism on the availability of life and other lines of insurance. The study was to have been completed by August 2003, 9 months after TRIA was enacted. As of March 1, 2004, according to Treasury officials, the report based on this study was in draft form. Because internal Treasury reviews of the draft have not been completed, the draft report has not yet been made public.

Pursuant to TRIA sections 104(f)(1) and 108(d)(1), Treasury officials said they began collecting data on annual premium rates and working on the study that would assess the effectiveness of TRIA and project the availability and affordability of terrorism insurance for certain groups of policyholders after TRIA expires. Treasury hired a private firm to collect premium data and other information in surveys from policyholders, insurers, and reinsurers. In the surveys, policyholders are asked to provide information such as business size, geographic locations of insured properties, premium data for TRIA-related terrorism insurance, and risk management measures used. Insurers are asked about the types of insurance sold that contain TRIA coverage, number of policies sold, number of policies sold with TRIA coverage, and methods used for estimating risks.[15] Reinsurers will be asked for similar information. The data collected from the survey will provide information for the data collection efforts on annual premium rates and also provide the basis for assessing the effectiveness of TRIA. According to Treasury officials, Treasury began sending surveys to a nationally representative sample of 25,000 policyholders in November 2003 and approximately 700 insurers and insurance groups in January 2004. The first surveys will collect data for 2003, as well as 2002, to establish a baseline for analysis and reporting. The second and third surveys will be sent in 2004 and 2005.

Treasury Has Tasks to Complete before TRIA Can Be Fully Implemented

Before TRIA can be fully implemented, Treasury has to make certain decisions, develop additional regulations, and make certain TRIP functions operational. More specifically, TRIA gave Treasury until September 1, 2004, to decide if the requirement that insurers offer terrorism coverage on terms that do not differ materially from other coverage should be extended for policies issued or renewed in 2005, the third and final year of the program. Treasury did issue a press release on December 23, 2003, clarifying that the

[15] Treasury has implemented mechanisms to ensure that sensitive business data on individual insurers would not be made public through the Freedom of Information Act.

“make available” requirement for annual policies issued or renewed in 2004 extends until the policy expiration date, even though the coverage period extends into 2005. As of March 1, 2004, Treasury officials said they had not made a decision on the “make available” extension for policies that will be issued or renewed in 2005. The officials indicated that they would be in a better position to make this decision after they obtained enough preliminary data from their surveys, which they anticipate receiving in spring 2004. The survey data are expected to provide an analytical framework for Treasury’s decisions by collecting information on factors such as premium rates, geographic locations of covered property, policy limits and deductibles, and the extent to which certain terrorism risks are covered.

Treasury has yet to develop all the regulations necessary to carry out TRIA provisions and make operational certain functions relating to claims administration, auditing, and oversight. While the implementation of some of these provisions and functions was covered by the proposed rule (see fig. 2), Treasury has not drafted final rules to cover the latter stages of the claims process, which would encompass resolving disputed claims with insurance companies, dealing with insurers that become insolvent, adjusting claims payments for over- and underpayments (netting), and handling claims submitted by insurers after aggregate insured losses have exceeded the $100 billion cap. Treasury officials said they plan to complete these regulations in the spring and summer of 2004, after they have fully addressed the claims-paying process. Treasury also has yet to write regulations addressing recoupment and surcharges and the collection of civil monetary penalties in cases of noncompliance or fraud. Treasury also plans to assess the need to develop additional regulations or refine past regulations on captive insurers and self-funded pools—types of self-insurers. Additionally, Treasury has not yet developed processes for auditing claims payments to insurers. However, Treasury plans to issue a request for proposal (RFP) for a postclaims auditing contractor in the third quarter of fiscal year 2004. The contractor will review claims and conduct field audits of insurers after an event to ensure that underlying documents support claims submitted to Treasury. Treasury officials anticipate awarding a contract in the fourth quarter of fiscal year 2004. Moreover, Treasury plans to develop guidance encompassing business procedures and audit parameters that will trigger reviews and audits. Treasury officials also said that other ongoing and completed work associated with the claims-processing function lays the foundation for the claims auditing process. Finally, a Treasury official estimated that by the end of fiscal year 2004, Treasury would implement all of the processes that would have to be in place before an event occurred. After fiscal year 2004, Treasury plans to develop procedures for requirements that will not need to be in place until after an event has occurred—such as recoupment and surcharge.

Lastly, a key TRIP function—the actual processing and payment of claims—is not yet operational. From the beginning of its planning efforts, Treasury had envisioned that contractors would handle TRIA claims processing in the aftermath of a terrorist attack. According to TRIP officials, after incorporating a basic regulatory framework, one of the first priorities for the TRIP office was to write and issue a RFP to procure contractors to perform claims services. Treasury issued an RFP for claims-processing and payment services in December 2003, but had not hired any contractors as of March 1, 2004. Treasury attempted to accelerate the procurement process by reducing the number of days allowed for bidders to respond to the RFP and dedicating all TRIP staff to reviewing the proposals. However, the number of proposals received has pushed the contract award date beyond original estimates of February 2004. Treasury officials now believe they will award a contract by April 2004. Treasury has also continued to develop a proposed rule, related guidance, claims management requirements for the claims contractor and processes necessary to manage the claims function, and worked with industry to devise standard forms. Moreover, once the claims processing contract is awarded, Treasury plans to establish electronic interfaces between itself and the contractor, test the contractor's systems and processes by using "dummy" claims submitted by insurers, and establish an electronic fund transferring process to speed reimbursement of insured losses.

NAIC Is Fulfilling Its Advisory Role under TRIA

NAIC is working with Treasury on various aspects of implementing TRIA, effectively fulfilling its advisory role. In January 2003, NAIC formed the Terrorism Insurance Implementation Working Group to work with Treasury. The working group consists of representatives from nine states and the District of Columbia, who are led by a state insurance commissioner, and has provided input to Treasury on an ongoing basis.[16] In particular, the working group assisted Treasury each time it issued

[16]In 2003, the working group was chaired by the insurance commissioner for the state of Iowa and representatives from the insurance departments of the District of Columbia, Florida, Montana, Nebraska, New Jersey, New York, North Dakota, Oklahoma, and South Dakota.

guidance and rules, according to Treasury and NAIC officials. For example, Treasury officials reported that NAIC aided them in writing a detailed definition for "insurer" for its first interim final rule published in the *Federal Register* in February 2003. NAIC coordinated meetings between Treasury and state insurance regulators to align or address differences in definitions that exist across the 50 states, the District of Columbia, Puerto Rico, and three U.S. territories. As noted previously, TRIA directed that state regulations be preserved when possible; thus, the definitions had to be highly consistent with state regulations. The NAIC official also explained that NAIC tried to ensure that the language of its suggestions to Treasury, when implemented, would be enforceable by all state insurance regulators.

NAIC also aided Treasury in outreach and education efforts. In the weeks before TRIA was enacted, NAIC issued press releases informing insurers of the impending act and urging them to prepare for its new requirements. Moreover, NAIC applied its expertise in developing a model bulletin, regulations, and forms to help state regulators and insurers expeditiously carry out TRIA responsibilities. For example, NAIC issued a model bulletin, which state regulators could use to communicate key terms and definitions and explain the application of TRIA to losses resulting from foreign sources versus domestic sources of terrorism. NAIC made the model bulletin available on its Web site immediately upon the enactment of TRIA. NAIC also developed model disclosure forms for insurers to use when informing their policyholders about the availability of terrorism insurance under TRIA. As discussed previously, TRIA requires insurers to send disclosure notices to their policyholders about the availability and cost of terrorism insurance and the 90 percent federal share.

Insurance Companies Made Changes to Their Operations to Comply with TRIA

In order to comply with TRIA requirements, primarily those concerning disclosure to policyholders, insurers generally have made changes to their operations. According to an official of a large insurance company, to develop and disseminate information about TRIA terms and coverage, insurers have changed policies, software, and forms; trained staff; revised actuarial information and underwriting procedures; and expanded outreach and marketing. For example, the insurers had to send revised premium information in disclosure notices to hundreds of thousands of policyholders as well as submit thousands of new premium rates and the associated policy language to state regulators for approval. If the insurers had failed to make these disclosures, they would have lost their eligibility for reimbursement under TRIA.

While the disclosure requirements required many revisions to insurer operations, the insurers did have the benefit of a "safe harbor." As previously discussed, Treasury determined that use of NAIC's model disclosure form constituted compliance with TRIA's disclosure requirements. Moreover, insurers using NAIC's model form could get coverage decisions from their policyholders without first investing time in devising a disclosure notice—a time-consuming process that would include review by an insurer's legal staff for compliance with TRIA requirements. Given that TRIA invalidated terrorism exclusions as soon as it was enacted, insurers were exposed to uncompensated risks (i.e., the potential for having to pay for all the losses in a terrorism event without having received a premium) until their existing policyholders received written disclosures, accepted the coverage, or rejected it.

Insurers Are Concerned That the Pace of TRIA Implementation Could Affect Business Planning, Reduce Cash Flow, or Result in Insolvency

Insurers have expressed a number of concerns about Treasury's implementation of TRIA. Insurers are concerned that Treasury has not already made a decision about extending the "make available" requirement through 2005; they are also concerned about the potential length of time it may take for the Secretary of the Treasury to certify a terrorist event, potential inefficiencies and time lags in processing and paying claims once an event is certified, and the issue of TRIA expiration. TRIA gives Treasury until September 2004 to make a decision about whether to require insurers to make terrorism insurance available—on terms that do not differ materially from that of other coverage—for policies issued or renewed in 2005, the third year of the program. Insurers have stated that this deadline is too late. Insurers need to make underwriting, price, and coverage decisions for these policies in mid-2004. However, Treasury has yet to make a decision about the "make available" requirement for policies issued or renewed in 2005.

If Treasury did not extend the requirements through 2005, insurers would have to evaluate and possibly revise prices and terms for newly issued and renewing policies, according to an insurance official. Moreover, regulatory approval for these changes might take longer than the time it took to approve the changes to policies and procedures that insurers initially made to implement TRIA. TRIA allowed for federal preemption of the states' authority to approve insurance policy rates and conditions, but the preemption expired on December 31, 2003—returning insurers to the previous regulatory scheme in which they must obtain regulatory approvals from each state that has these requirements to sell insurance. Thus, the timing of Treasury's announcement on the extension may cost both companies and policyholders money if policy changes cannot be implemented in time to issue or renew policies.

Insurers also are concerned that a delay in Treasury's certification of a terrorist event as eligible for federal reimbursement, in conjunction with state regulations requiring prompt payment of claims, could create cash flow problems or even lead to insolvency for some insurers. While TRIA does not specify the length of time available for determining whether an event meets the criteria for certification, insurers are bound by law and regulations in most states to pay claims in a timely manner, which means they may have to pay policyholder claims in full without waiting for Treasury to certify an event, said an NAIC official.

Because of this requirement to pay claims in a timely manner, insurers face potentially negative financial consequences under two possible scenarios: if Treasury made the certification decision after an extended period of time or if Treasury ultimately made the decision not to certify an event after an extended period of time.

Under the first scenario, insurance industry observers have said that they could potentially experience a cash flow problem while awaiting a certification decision, and thus for reimbursement of the 90 percent federal share, because they have already paid 100 percent of the claimed losses. Insurers brought up the anthrax letter incidents as an example of their concerns about certification time frames, because law enforcement officials still have not identified the source, whether foreign or domestic, more than 2 years after the incidents. Under the second scenario, insurers could become insolvent if Treasury decided not to certify an event (i.e., decided the act was not the work of terrorists working on behalf of foreign interests) after insurers had already paid policyholder claims. Unless the policyholder had paid for coverage of all terrorist events—including those caused by domestic terrorists, which would be excluded from reimbursement under TRIA—insurers would have paid for losses for which they had collected no premium. Insurers would have no way to recover payments already made to policyholders for losses associated with the event other than to seek remedies through the courts, an NAIC official explained.

Treasury has responded that the certification process is complex and possibly would require extensive investigation and correlation of information from many sources, most not under Treasury's control. As a result, although Treasury officials said that they understood the difficulties facing insurers, they also felt that placing specific time limits on those making the certification decision would impose unworkable constraints on an already complex and difficult process. Treasury has taken some steps to facilitate the certification process by communicating with the Department of Justice and the Department of State. Specifically, Treasury has identified contacts within these agencies and has met with relevant individuals to discuss their roles in the certification process.

Insurers are also concerned that the length of time Treasury may take to process and pay claims could impact an insurer's cash flow. Treasury's capacity to pay claims relatively quickly will determine how fast insurers receive the 90 percent federal share. According to an insurance company official, because of the long-standing relationships and familiarity that insurers have with reinsurers, it is often possible to receive speedy payment for losses.[17] Insurers are concerned that this might not be possible with the TRIP office, especially since the claims-paying mechanism has yet to be created. Treasury officials explained that without a close preexisting relationship like that between an insurer and reinsurer, some procedures may, of necessity, differ. As noted previously, Treasury published a proposed rule addressing the claims-paying process. However, the proposed rule does not specify the maximum number of days in which Treasury must pay claims. According to a Treasury official, establishing a time frame for payment would not be appropriate. However, to address insurer concerns about prompt payment, Treasury has taken into consideration input received from the insurance industry and has been developing mechanisms to expedite the review, approval, and payment of claims. Treasury has also decided to use electronic fund transfers to insurer's accounts to speed reimbursement to insurers with approved claims. Treasury officials said such a mechanism should reduce the potential for insurers to experience cash flow problems by eliminating the wait for Treasury to issue checks.

Finally, insurance industry officials are worried that uncertainty about TRIA's extension past 2005 will impede their business and planning

[17]For example, the insurance official explained that to abate the risk in lines of business that cover catastrophic risks such as terrorism, an insurer would typically obtain reinsurance. Through repeated interactions, the insurer and reinsurer develop a relationship in which the reinsurer becomes familiar with the insurer's operations and finances. When a catastrophe strikes, the reinsurer is already familiar with the information that is necessary to substantiate the claims and can pay the insurer without first completing a review of the insurer's accounting information; differences in over- or underpayment are settled later.

processes. Although TRIA does not contain any specific extension provisions, Treasury officials have used forums such as NAIC and industry meetings to state that TRIA was designed to provide a program of three years duration. However, industry participants continue to believe that an extension is both possible and likely. As a result, they are concerned that a late decision to extend TRIA would create confusion and disarray in the industry because of the lead time needed to tailor business operations and plans to an insurance environment with TRIA or a federal government backup or, alternatively, without one.

Despite Availability, Few Are Buying Terrorism Insurance, and the Industry Has Made Little Progress toward Post-TRIA Coverage

While TRIA has improved the availability of terrorism insurance, particularly for high-risk properties in major metropolitan areas, most commercial policyholders are not buying the coverage. Limited industry data suggest that 10 to 30 percent of commercial policyholders are purchasing terrorism insurance, perhaps because most policyholders perceive themselves at relatively low risk for a terrorist event. Some industry experts are concerned that those most at risk from terrorism are generally the ones buying terrorism insurance. In combination with low purchase rates, these conditions could result in uninsured losses for those businesses without terrorism coverage or cause financial problems for insurers, should a terrorist event occur. Moreover, even policyholders who have purchased terrorism insurance may remain uninsured for significant risks arising from certified terrorist events involving NBC agents, radioactive contamination, or fire following the events. Finally, although insurers and some reinsurers have cautiously reentered the terrorism risk market, insurance industry participants have made little progress toward developing a mechanism that could permit the commercial insurance market to resume providing terrorism coverage without a government backstop.

TRIA Has Improved the Availability of Terrorism Insurance, and Some High-Risk Policyholders Have Bought Coverage

TRIA has improved the availability of terrorism insurance, especially for some high-risk policyholders. According to insurance and risk management experts, these were the policyholders who had difficulty finding coverage before TRIA. Although industry data on policyholder characteristics are limited and cannot be generalized to all policyholders in the United States, risk management and real estate representatives generally agree that after TRIA was passed, policyholders—including borrowers obtaining mortgages for "trophy" properties, owners and developers of high-risk properties in major city centers, and those in or near "trophy" properties—were able to purchase terrorism insurance.

Additionally, TRIA contributed to better credit ratings for some commercial mortgage-backed securities. For example, prior to TRIA's passage, the credit ratings of certain mortgage-backed securities, in which the underlying collateral consisted of a single high-risk commercial property, were downgraded because the property lacked or had inadequate terrorism insurance. The credit ratings for other types of mortgage-backed securities, in which the underlying assets were pools of many types of commercial properties, were also downgraded but not to the same extent because the number and variety of properties in the pool diversified their risk of terrorism. Because TRIA made terrorism insurance available for the underlying assets, thus reducing the risk of losses from terrorist events, it improved the overall credit ratings of mortgage-backed securities, particularly single-asset mortgage-backed securities. Credit ratings affect investment decisions that revolve around factors such as interest rates because higher credit ratings result in lower costs of capital. According to an industry expert, investors use credit ratings as guidance when evaluating the risk of mortgage-backed securities for investment purposes. Higher credit ratings reflect lower credit risks. The typical investor response to lower credit risks is to accept lower returns, thereby reducing the cost of capital, which translates into lower interest rates for the borrower.

Most Policyholders Have Not Bought Terrorism Insurance

Although TRIA improved the availability of terrorism insurance, relatively few policyholders have purchased terrorism coverage. We testified previously that prior to September 11, 2001, policyholders enjoyed "free" coverage for terrorism risks because insurers believed that this risk was so low that they provided the coverage without additional premiums as part of the policyholder's general property insurance policy.[18] After September 11, prices for coverage increased rapidly and, in some cases, insurance became very difficult to find at any price. Although a purpose of TRIA is to make terrorism insurance available and affordable, the act does not specify a price structure.

[18]GAO-02-472T.

However, experts in the insurance industry generally agree that after the passage of TRIA, low-risk policyholders (e.g., those not in major urban centers) received relatively low-priced offers for terrorism insurance compared to high-risk policyholders, and some policyholders received terrorism coverage without additional premium charges.[19] Yet according to insurance experts, despite low premiums, many businesses (especially those not in "target" localities or industries) did not buy terrorism insurance. Some simply may not have perceived themselves at risk from terrorist events and considered terrorism insurance, even at low premiums (relative to high-risk areas), a bad investment.[20] According to insurance sources, other policyholders may have deferred their decision to buy terrorism insurance until their policy renewal date.

Some industry experts have voiced concerns that low purchase rates may indicate adverse selection—where those at the most risk from terrorism are generally the only ones buying terrorism insurance. Although industry surveys are limited in their scope and not appropriate for market-wide projections, the surveys are consistent with each other in finding low "take-up" rates, the percentage of policyholders buying terrorism insurance, ranging from 10 to 30 percent. According to one industry survey, the highest take-up rates have occurred in the Northeast, where premiums were generally higher than the rest of the country.

The combination of low take-up rates and high concentration of purchases in an area thought to be most at risk raises concerns that, depending on its location, a terrorist event could have additional negative effects.

- If a terrorist event took place in a location not thought to be a terrorist "target," where most businesses had chosen not to purchase terrorism insurance, then businesses would receive little funding from insurance claims for business recovery efforts, with consequent negative effects on owners, employers, suppliers, and customers.

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[19]According to industry experts, the insurers that provided "free" terrorism insurance likely did so for policies already in place at the time TRIA was enacted and may have deferred operational changes and difficult pricing decisions because they lacked the resources to do so.

[20]Howard Kunreuther, Erwann Michel-Kerjan, and Beverly Porter, *Assessing, Managing and Financing Extreme Events: Dealing with Terrorism* (National Bureau of Economic Research: December 2003), 13.

- Alternatively, if the terrorist event took place in a location deemed to be a "target," where most businesses had purchased terrorism insurance, then adverse selection could result in significant financial problems for insurers. A small customer base of geographically concentrated, high-risk policyholders could leave insurers unable to cover potential losses facing possible insolvency. If, however, a higher percentage of business owners had chosen to buy the coverage, the increased number of policyholders would have reduced the chance that losses in any one geographic location would create a significant financial problem for an insurer.[21]

Tighter Exclusions Leave Policyholders Exposed to Significant Perils

Since September 11, 2001, the insurance industry has moved to tighten long-standing exclusions from coverage for losses resulting from NBC attacks and radiation contamination. As a result of these exclusions and the actions of a growing number of state legislatures to exclude losses from fire following a terrorist attack, even those policyholders who choose to buy terrorism insurance may be exposed to potentially significant losses. Although NBC coverage was generally not available before September 11, after that event insurers and reinsurers recognized the enormity of potential losses from terrorist events and introduced new practices and tightened treaty language to further limit as much of their loss exposures as possible. (We discuss some of these practices and exclusions in more detail in the next section.) State regulators and legislatures have approved these exclusions, allowing insurers to restrict the terms and conditions of coverage for these perils. Moreover, because TRIA's "make available" requirements state that terms for terrorism coverage be similar to those offered for other types of policies, insurers may choose to exclude the perils from terrorism coverage just as they have in other types of coverage. According to Treasury officials, TRIA does not preclude Treasury from providing reimbursement for NBC events, if insurers offered this coverage. However, policyholder losses from perils excluded from coverage, such as NBCs, would not be "insured losses" as defined by TRIA and would not be covered even in the event of a certified terrorist attack.

In an increasing number of states, policyholders may not be able to recover losses from fire following a terrorist event if the coverage in those states is not purchased as part of the offered terrorism coverage. We have

[21]Casualty Actuarial Society, *Foundations of Casualty Actuarial Science*, 4th ed. (United Book Press, Inc.: 2001), 51, 86.

previously reported that approximately 30 states had laws requiring coverage for "fire-following" an event —known as the standard fire policy (SFP)—irrespective of the fire's cause.[22] Therefore, in SFP states fire following a terrorist event is covered whether there is insurance coverage for terrorism or not. After the terrorist attacks of September 11, 2001, some legislatures in SFP states amended their laws to allow the exclusion of fire following a terrorist event from coverage. As of March 1, 2004, 7 of the 30 SFP states had amended their laws to allow for the exclusion of acts of terrorism from statutory coverage requirements.[23] However as discussed previously, the "make available" provision requires coverage terms offered for terrorist events to be similar to coverage for other events. Treasury officials explained that in all non-SFP states, and the 7 states with modified-SFPs, insurers must include in their offer of terrorism insurance, coverage for fire following a certified terrorist event because coverage for fire is part of the property coverage for all other risks. Thus, policyholders who have accepted the offer would be covered for fire following a terrorist event, even though their state allows exclusion of the coverage. However, policyholders who have rejected their offer of coverage for terrorism insurance would not be covered for fire following a terrorist event. According to insurance experts, losses from fire damage can be a relatively large proportion of the total property loss. As a result, excluding terrorist events from SFP requirements could result in potentially large losses that cannot be recovered if the policyholder did not purchase terrorism coverage. For example, following the 1994 Northridge earthquake in California, total insured losses for the earthquake were $15 billion—$12.5 billion of which were for fire damage. According to an insurance expert, policyholders were able to recover losses from fire damage, because California is an SFP state, even though most policies had excluded coverage for earthquakes.

[22] GAO-02-472T.

[23] According to the National Association of Mutual Insurance Companies, Louisiana, Michigan, Minnesota, Nebraska, New Hampshire, Oklahoma, and Virginia have amended their standard fire policy to allow for exclusion of terrorism from their statutory fire coverage. State legislators in Massachusetts have introduced a similar bill.

Reinsurers Have Cautiously Returned to the Terrorism Insurance Market, but Many Insurers Have Not Bought Reinsurance

Under TRIA, reinsurers are offering a limited amount of coverage for terrorist events, specifically for the insurer deductibles and 10 percent share, but insurers have not been buying much of this reinsurance. According to insurance industry sources, TRIA's ceiling on potential losses has enabled reinsurers to return cautiously to the market. That is, reinsurers generally are not offering coverage for terrorism risk beyond the limits of the insurer deductibles and the 10 percent share that insurers may have to pay under TRIA. In spite of reinsurers' willingness to offer this coverage, company representatives have said that many insurers have not purchased reinsurance. Insurance experts suggested that the low demand for the reinsurance might reflect, in part, commercial policyholders' generally low take-up rate for terrorism insurance. Moreover, insurance experts also have suggested that insurers may believe that the price of reinsurance is too high relative to the premiums they are earning from policyholders for terrorism insurance.

The relatively high prices charged for the limited amounts of terrorism reinsurance available are probably the result of interrelated factors. First, even before September 11 both insurance and reinsurance markets were beginning to harden; that is, prices were beginning to increase after several years of lower prices. Reinsurance losses resulting from September 11 also depressed reinsurance capacity and accelerated the rise in prices.[24] The resulting hard market for property-casualty insurance affected the price of most lines of insurance and reinsurance. A notable example has been the market for medical malpractice insurance.[25] The hard market is only now showing signs of coming to an end, with a resulting stabilization of prices for most lines of insurance. In addition to the effects of the hard market, reinsurer awareness of the adverse selection that may be occurring in the commercial insurance market could be another factor contributing to higher reinsurance prices. Adverse selection usually represents a larger-than-expected exposure to loss. Reinsurers are likely to react by increasing prices for the terrorism coverage that they do sell.

In spite of the reentry of reinsurers into the terrorism market, insurance experts said that without TRIA caps on potential losses, both insurers and reinsurers likely would still be unwilling to sell terrorism coverage because

[24] Capacity is the amount of reinsurance or insurance that is available for a defined risk.

[25] U.S. General Accounting Office, *Medical Malpractice Insurance: Multiple Factors Have Contributed to Increased Premium Rates*, GAO-03-702 (Washington, D.C.: June 27, 2003).

they have not found a reliable way to price their exposure to terrorist losses. According to industry representatives, neither insurers nor reinsurers can estimate potential losses from terrorism or determine prices for terrorism insurance without a pricing model that can estimate both the frequency and the severity of terrorist events. Reinsurance experts said that current models of risks for terrorist events do not have enough historical data to dependably estimate the frequency or severity of terrorist events, and therefore cannot be relied upon for pricing terrorism insurance. According to the experts, the models can predict a likely range of insured losses resulting from the damage if specific event parameters such as type and size of weapon and the location are specified. However, the models are unable to predict the probability of such an attack.

Even as they are charging high prices, reinsurers are covering less. In response to the losses of September 11, industry sources have said that reinsurers have changed some practices to limit their exposures to acts of terrorism. For example, reinsurers have begun monitoring their exposures by geographic area, requiring more detailed information from insurers, introducing annual aggregate limits and event limits, excluding large insurable values, and requiring stricter measures to safeguard assets and lives where risks are high.[26] And as discussed previously, almost immediately after September 11 reinsurers began broadening NBC exclusions beyond scenarios involving industrial accidents, such as nuclear plant accidents and chemical spills, to encompass intentional destruction from terrorists. For example, post-September 11 exclusions for nuclear risks include losses from radioactive contamination to property and radiation sickness from dirty bombs.

As of March 1, 2004, industry sources indicated that there has been little development or movement among insurers or reinsurers toward developing a private-sector mechanism that could provide capacity, without government involvement, to absorb losses from terrorist events. Industry officials have said that their level of willingness to participate more fully in the terrorism insurance market in the future will be determined, in part, by whether any more events occur. Industry sources could not predict if reinsurers would return to the terrorism insurance market after TRIA expires, even after several years and even if no more major terrorist attacks were to occur in the United States. They explained

[26]Christian Brauner and Georges Galey, "Terrorism Risks in Property Insurance and Their Insurability after 11 September 2001," (Swiss Reinsurance Company: 2003), 25.

that reinsurers are still recovering from the enormous losses of September 11 and still cannot price terrorism coverage. In the long term and without another major terrorist attack, insurance and reinsurance companies might eventually return. However, should another major terrorist attack take place, reinsurers told us that they would not return to this market—with or without TRIA.

Conclusions

TRIA gave Treasury a very challenging task—to develop what is effectively the world's largest reinsurer. This task was complicated by the very real possibility that Treasury could have been called on to perform at any time, without advance notice. More than a year after TRIA took effect, key pieces of this reinsurance entity are either in place or nearly in place. Perhaps most importantly for Treasury, the U.S. government, and the American people, no further terrorist attack, major or minor, has yet occurred on American soil. In spite of this breathing space and all that Treasury has accomplished, considerable work remains. Key components of the Terrorism Risk Insurance Program defined by TRIA remain uncompleted. At best, all the components will be in place shortly before the second anniversary of the 3-year program. Recognizing the complexity of the task, it is difficult to be critical, particularly given the lack of a terrorist event. However, had an attack occurred, the incomplete preparation could have added to the plight of the victims.

Congress had two major objectives in establishing TRIA. The first was to ensure that business activity did not suffer from the lack of insurance by requiring insurers to continue to provide protection from the financial consequences of another terrorist attack. Since TRIA was enacted in November 2002, terrorism insurance generally has been available to businesses. While most have not purchased this coverage, purchases have been higher in areas considered to be at high risk of another terrorist attack. Quantifiable evidence is lacking on whether having TRIA coverage available has contributed to the economy. However, the current revival of economic activity suggests that the decision of most commercial policyholders to decline terrorism coverage has not resulted in widespread, negative economic effects. As a result, the first objective of TRIA appears largely to have been achieved.

Congress's second objective was to give the insurance industry a transitional period during which it could begin pricing terrorism risks and developing ways to provide such insurance after TRIA expires. The insurance industry has not yet achieved this goal. We observed after

September 11 the crucial importance of reinsurers for the survival of the terrorism insurance market and reported that reinsurers' inability to price terrorism risks was a major factor in their departure from the market.[27] Additionally, most industry experts are tentative about predictions of the level of reinsurer and insurer participation in the terrorism insurance market after TRIA expires. Unfortunately, insurers and reinsurers still have not found a reliable method for pricing terrorism insurance, and although TRIA has provided reinsurers the opportunity to reenter the market to a limited extent, industry participants have not developed a mechanism to replace TRIA. As a result, reinsurer and, consequently, insurer participation in the terrorism insurance market likely will decline significantly after TRIA expires.

Not only has no private-sector mechanism emerged for supplying terrorism insurance after TRIA expires, but also to date there has been little discussion of possible alternatives for ensuring the availability and affordability of terrorism coverage after TRIA expires. Congress may benefit from an informed assessment of possible alternatives—including both wholly private alternatives and alternatives that could involve some government participation or action. Such an assessment could be a part of Treasury's TRIA-mandated study to "assess…the likely capacity of the property and casualty insurance industry to offer insurance for terrorism risk after termination of the Program."

Recommendation for Executive Action

As part of the response to Treasury's TRIA-mandated study requiring an assessment of the effectiveness of TRIA and evaluating the capacity of the industry to offer terrorism insurance after TRIA expires, we recommend that the Secretary of the Treasury, after consulting with the insurance industry and other interested parties, also identify for Congress an array of alternatives that may exist for expanding the availability and affordability of terrorism insurance after TRIA expires. These alternatives could assist Congress during its deliberations on how best to ensure the availability and affordability of terrorism insurance after December 2005.

Agency Comments

We requested comments on a draft of this report from the head of the Department of the Treasury or his designee. The Assistant Secretary for

[27] GAO-02-472T.

Financial Institutions at Treasury provided written comments that are included in appendix I stating, in general, that Treasury believed our report provided a thorough and well-balanced discussion of the impact and implementation of the Terrorism Risk Insurance Act of 2002. These written comments also provided amplification of certain points related to Treasury's implementation of the Act. For example, Treasury commented that its "… implementation of TRIA has been guided by prioritizing the actions that were needed to make the program operational right away." Treasury also described the emergency procedures in place since "the early days of the program." Treasury believes these contingency plans would have allowed it to establish and implement a process for receiving, reviewing, and paying claims that would have enabled it to respond quickly to a terrorist event, if it had been necessary. Treasury also provided technical comments on the report that were incorporated as appropriate.

As agreed with your offices, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days after its issuance date. At that time, we will send copies of this report to the Chair and Ranking Minority Member, Senate Committee on Banking, Housing and Urban Affairs; the Ranking Minority Member, Committee on Financial Services, House of Representatives; and other interested congressional members and committees. We will also make copies available to others upon request. In addition, this report will also be available at no charge on GAO's Web site at http://www.gao.gov.

This report was prepared under the direction of Lawrence D. Cluff, Assistant Director. If you or your staff have any questions regarding this report, please contact the Assistant Director or me at (202) 512-8678. Barry Kirby, Tarek Mahmassani, Angela Pun and Barbara Roesmann also made key contributions to this report.

Sincerely yours,

Richard J. Hillman
Director, Financial Markets
and Community Investments

Comments from the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

April 15, 2004

Mr. Richard J. Hillman
Director of Financial Markets and Community Investment
United States General Accounting Office
411 G Street, NW
Washington, DC 20508

Dear Mr. Hillman:

Thank you for providing the United States Department of the Treasury the opportunity to comment on the General Accounting Office's (GAO) report entitled "Terrorism Insurance: Implementation of the Terrorism Risk Insurance Act of 2002."

In general, we believe the GAO has drafted a thorough, well-balanced report on the impact and implementation of the Terrorism Risk Insurance Act of 2002 (TRIA). As it relates to the implementation of TRIA, we would like to stress a couple of points:

First, because TRIA became effective immediately on November 26, 2002, when the President signed the bill into law, Treasury's implementation of TRIA has been guided by prioritizing the actions that were needed to make the program operational right away. To meet this challenge, Treasury issued three interim guidance notices from December 3, 2002, through January 22, 2003. These actions and formal rulemakings that took place beginning in early 2003, set forth the basic framework of TRIA; they provided the insurance industry with the information and guidance to make the Program operational on the part of insurance companies, enabling the companies, for example, to comply with policyholder disclosure requirements and the "make available" requirement, calculate their insurer deductibles, and understand the scope of the Program.

Second, from the early days of the program we have been prepared at short notice to be able to process claims, initially standing ready to exercise emergency procurement and regulatory procedures to implement a claims process expeditiously if needed, while moving forward under more formal procedures to develop a more regular claims process. The subsequent development of the formal claims procedures regulation also reflects Treasury's prioritization of issues. The proposed claims regulation that was published on December 1, 2003, sets forth a complete framework for the claims process under the Program. In conjunction with this rulemaking, Treasury has also developed detailed operating procedures and forms for claims filing, processing and payment, which will be issued under the authority of this regulation. Other issues secondary to those associated with the claims process (e.g., final netting of losses and how to address the $100 billion cap) being of a lower operational priority, will be addressed subsequently—though we will continue to be ready to invoke expedited procedures in this case as well should the need arise.

In summary, the extensive work done by Treasury in developing the basic framework of TRIA through interim guidance notices and regulations, the proposed claims regulations, the drafting of claims forms and review with industry organizations and the National Association of Insurance Commissioners, and contingency procurement plans, all have contributed to the Department being ready to respond in case of a covered event from the very early days of the Program.

In addition to these general comments, we have separately provided technical comments to your staff and hope that such comments were useful. Thank you again for the opportunity to comment on your report.

Sincerely,

Wayne A. Abernathy
Assistant Secretary for Financial Institutions

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