

Federal Terrorism Insurance Program Renewed

BY JOHN R. WALTER

On Dec. 22, 2005, President Bush signed legislation renewing the Terrorism Risk Insurance Act of 2002 (TRIA), which otherwise would have expired Dec. 31. TRIA was enacted, as a temporary measure, in response to the attacks of Sept. 11, 2001. It was intended to ensure the availability of insurance covering businesses' losses resulting from any future terrorist attack. The renewal lasts until 2007.

Following the Sept. 11 attacks, the price of terrorism coverage rose. The media carried stories of lenders withdrawing support from commercial construction projects because of these projects' inability to acquire terrorism coverage at a feasible price. Observers were fearful of possible macroeconomic effects if construction declined, especially in a then recession-weakened business environment.

TRIA promised that the federal government would reimburse property and casualty insurance companies for most of the claims they paid, above a specified amount, due to any future terrorist attack. It also required all commercial property and casualty insurers to offer terrorism coverage to their customers.

According to the text of the law, its purpose is to "ensure the continued widespread availability and affordability of property and casualty insurance for terrorism risk; and allow for a transitional period for the private markets to stabilize ... and build capacity to absorb any future losses..." By these measures, the law appears to have been successful. According to a recent study by the Department of Treasury, the number of businesses with terrorism coverage increased, and prices declined, after TRIA was implemented.

The federal government provides reimbursement to firms if the following two conditions are met: First, the terrorist attack must produce at least, in aggregate, \$50 million in 2006 and \$100 million in 2007 in insured losses. Second, before the Treasury provides any reimbursement the insurer must have met a deductible which it pays out of its own funds. Once the deductible is met the Treasury reimburses the insurer for 90 percent in 2006 and 85 percent in 2007 of its terrorist claims. The percentage deductible increased from 1 percent of all premiums collected by an insurance company, immediately following the law's enactment to 17.5 percent in the program's fourth year, 2006, and 20 percent in 2007.

At base, TRIA provides public backing for the liabilities of private insurance companies, helping insurers to meet their obligations to their policyholders. Such government backing is not unusual. For example, the Federal Deposit Insurance Act of 1933 established the FDIC to back deposits held in banks. What is unusual about TRIA is that it offers this backing free of charge, unlike the FDIC which charges premiums.

Since there are no charges associated with TRIA protection, the program provides a subsidy to insurers — and if the commercial insurance market is competitive, to policyholders as well. When the government provides a subsidy, economists worry that too much of the subsidized good will be produced. Given the subsidy of terrorism insurance, companies may take less account of the danger of terrorist attack than they should when making important business decisions. Too many buildings may be built in risky locations, and too little effort may be devoted to building structures that would withstand an attack, or to investing in security efforts. When all such decisions are combined, the final effect could be greater exposure to losses due to terrorist attack than would be the case without the subsidy.

The government could limit these distortions by charging risk-adjusted premiums for the insurance coverage it provides. (It's worth noting that this would not solve the problem entirely. Even if it were priced, government-provided terrorism insurance would likely produce some market distortions.) The FDIC, for instance, charges higher premiums to banks judged more likely to fail. By doing so, the subsidy is reduced.

Why does TRIA not include a provision for risk-adjusted premiums? While the legislative history of the law is unclear on this point, there are several possible reasons. For instance, determining the risk could be quite difficult — perhaps more difficult than determining the risk of bank failure. How much more subject to terrorist attack is a building in New York than one in Atlanta, or in Peoria? No one knows the answer for sure, but a risk-adjusted premium must account for such differences.

Still, most analysts think that terrorist attacks are more likely to take place in large cities than in small ones. This has important implications. Economists have argued that there exist large economic benefits to bringing workers together in a concentrated area. But given that terrorist attacks are more likely in large cities, people have reason to avoid these locations. This could impose significant social costs. If TRIA makes locating in large cities more desirable, some of those costs could be offset.

On balance, then, the effects of the federal terrorism insurance program are unclear. It almost surely has distorted some firms' decisionmaking about construction and security. At the same time, it may have kept some firms from fleeing major metropolitan areas, despite the advantages of being in those cities. A fuller examination of its costs and benefits awaits.

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