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Implications of the Expiration of TRIA

With Congress adjourned for the year without extending the Terrorism Risk Insurance Act (TRIA), the program will expire on December 31st. The below document lays out some of the potential marketplace implications due to Congressional inaction.

How We Got Here

In another example of Washington, D.C. gridlock, on Tuesday, December 16, 2014 the U.S. Senate surprised the insurance marketplace and adjourned for the year without extending TRIA. This move was all the more surprising because TRIA enjoyed broad bipartisan support in both chambers of Congress. Only days earlier the U.S. House of Representatives had passed S. 2244, the "Terrorism Risk Insurance Reauthorization Act," which would have extended TRIA for six years with an overwhelming bipartisan vote of 417 – 7 and earlier this summer the Senate had already passed a similar TRIA bill by a 93-4 vote. While there is plenty of blame to go around, at the end of the day Senate leadership refused to stay in town to overcome the objection of one Senator: Senator Tom Coburn from Oklahoma who is retiring at the end of the year. Senator Coburn objected to the NARAB II agent licensing provision which was also included in the TRIA bill and had already been overwhelmingly passed in the House. While Senator Coburn had a "hold" on the legislative package, this could have easily been overcome by Senate Democrat leadership if they had chosen to devote the necessary floor time by invoking cloture and staying in town several additional days. Efforts are already underway to convince Congress to act quickly in the 114th Congress to begin early next year and initial indications from House and Senate leadership are that TRIA will be a high priority.

Insurance Marketplace Impact

According to the Insurance Information Institute (III), "market stability in terms of both pricing and availability of terrorism coverage, as well as the ability to maintain adequate and expanding levels of capacity over time, are contingent on the continued existence of TRIA. Without a federal backstop, terrorism risk insurance would almost certainly become less available. Any coverage that would be available likely would be more costly and/or limited in scope." In fact, in 2013 and 2014, Marsh conducted interviews in which they found that approximately 48 percent of property insurers said they would not offer stand-alone terrorism coverage should the program expire.

Individual Insurer Response

Agents and brokers are receiving notices from individual insurers on their plans for handling terrorism insurance post 12-31-14. Decisions will be made on an insurer by insurer basis, and in many cases a policy by policy basis. Individual insurers will decide how to handle terrorism insurance coverage after 12-31-14 based on their specific exposures, risk diversification, capital, and access to the limited private reinsurance market for terrorism risk. Based on numerous discussions with the carrier community, generally speaking larger insurers are expected to be in a better position than smaller and mid-size insurers to cover the risk. Some insurers could decide to include coverage for conventional attacks but not nuclear, biological, chemical, and radiological (NBCR) attacks. Other insurers could decide to cover their current business but not new business. Another option is that companies could decide to cover certain regions of the country while not covering others or they could decide to cover suburban areas but not urban areas. Company decisions will also be based on a calculation regarding the prospects for Congressional action on TRIA early next year. Initially it appears that many insurers are taking a wait and see approach and not making major changes to terrorism coverage until a new Congress has had a chance to consider a TRIA renewal. Because of this varied response by insurers it is important that agents and brokers immediately determine how **ALL** of their carrier partners are planning to respond as 1-1-15 approaches.

According to Standard & Poor's, "large insurers with the highest terrorism exposures are more focused on maintaining underwriting stability through this period of uncertainty, alleviating our concerns about short-term market disruption. Insurers will be careful about any abrupt actions, such as significant cancellations or changing underwriting guidelines that could damage relationships with agents, customers, and brokers." It should be noted that while underwriting behavior should remain stable in the near term, underwriters will be closely following the legislative process in 2015 and their behavior could change depending on Congressional action or inaction. Standard & Poor's still expects, "insurers to use terrorism exclusions in lines and states where such are allowed, or to add sublimits for NBCR events, particularly around key target areas of concentrated risk. In addition, terrorism coverage will not go away completely in commercial property policies, as 14 states require insurers to offer coverage for fire damage from terrorism as part of standard commercial property policies (Fire Following). Some insurers have also opted not to issue conditional terrorism exclusion endorsements on existing policies for competitive purposes."

The effect of TRIA's lapse is expected to be felt the most in the workers compensation market. It is important to note that workers compensation statutes rigidly define the terms of coverage. Since workers compensation is statutory, and carriers cannot exclude for cause, there cannot be terrorism risk exclusions on a workers compensation policy. The carrier's only choice is to provide terrorism coverage or decline the entire risk. According to a report by Rand Corporation, "If reinsurers are unwilling to provide much more coverage for both conventional and NBCR attacks, insurers could respond to TRIA's expiration by declining to provide workers compensation coverage to employers who present a high geographic concentration of potential losses. Without TRIA in place, employers perceived to be at high risk for terrorism might have to obtain coverage in residual markets, which could charge higher premiums." This adverse selection in the residual funds is already causing concern amongst many governors and state legislators.

Current State of Stand-alone Terrorism Insurance Market

According to the III, Marsh estimates that approximately $750 million to $2 billion per risk in stand-alone capacity is available to companies that do not have sizeable exposures in locations where insurers have aggregation problems. Capacity excess of $2 billion is also available but is more costly. In addition, the III goes on to say, "that only a very limited number of insurers have the capacity to offer large limits of coverage in the stand-alone market. Moreover, the capacity that exists in the market today exists, in large part because of the existence of TRIA. In the absence of TRIA, the aggregate amount of coverage would fall dramatically. Finally, the stand-alone coverage available in the market today is generally confined to property risks and does not include workers compensation exposure."

Reinsurance Market Impact

According to Standard & Poor's, "currently, aggregate private-market capacity is anywhere from $3 billion to $4 billion per risk. Furthermore, capacity in high-risk areas where insurers may have aggregation issues is still only approximately $1 billion per risk, which Standard & Poor's views as underinsured. Standard & Poor's goes on to note that "the absence of TRIA could spark an increase in demand for terrorism reinsurance that could ease the imbalance between the reinsurance industry's ample capital and otherwise stagnant demand. The longer TRIA remains absent, the more likely increased demand will spark higher terrorism reinsurance rates. As a result, more reinsurance capacity could become available in traditional form, and if demand becomes sufficiently strong, alternative capital sources could enter at the margins. However, we do not view additional private-market capacity to be sufficient to replace the $100 billion provided by TRIA. For Jan. 1, 2015 property catastrophe renewals, coverage extensions like terrorism may be more difficult to secure as reinsurers may use the changed market dynamics to resist rate declines and pressure to expand coverage. Nevertheless, we expect reinsurance market conditions to remain difficult despite the potential increase in demand from terrorism."

Rating Agency Reaction

The initial response from rating agencies has been somewhat muted, as they have not announced major ratings changes at this time. It is important to note that if TRIA is not extended early next year this could change.

Standard & Poor's Rating Services does not expect to take widespread rating actions on U.S. insurers or on their outstanding commercial mortgage-backed securities (CMBS) ratings based on Congressional inaction. Standard & Poor's goes onto say that the insurers they rate, "in general, are coming from a position of capital strength with excess capital for their rating levels according to our propriety risk-based capital model. This should provide them a cushion against unexpected losses."

A.M. Best has also weighed in on the issue and has said that it, "has determined that no rating actions on insurers previously identified as over-reliant upon TRIA are necessary at this time." A.M. Best went on to explain the decision by noting that, "all of the rating units deemed overly reliant upon [TRIA] were brought before a rating committee to evaluate action plans that would be implemented in the event [TRIA] was not renewed or if its protection was materially altered. After a thorough review of these action plans, it was determined that sufficient mitigation initiatives were developed to avoid a material impact on a rating unit's financial strength."

Moody's says, "the failure of the U.S. Senate last Tuesday to pass the Terrorism Risk Insurance Program Reauthorization Act of 2014 (TRIPRA 2014) is credit negative for U.S. commercial mortgage-backed securities (CMBS). Given the overwhelming bipartisan support TRIPRA 2014 evidenced prior to its sudden demise earlier this week, Moody's believes it highly likely - though not certain - that some type of reauthorization of the federal backstop for terrorism insurance will emerge fairly early in the legislative session when Congress reconvenes on January 6, 2015. However, a repeat failure to renew, or a prolonged delay in renewing, the terrorism backstop could have material negative credit and ratings consequences for both US commercial real estate and for certain classes of rated CMBS. Moody's goes on to say that it, "will continue to closely monitor CMBS transactions that may have particular exposure to inadequate terrorism insurance as Congress considers the renewal of the federal backstop in January and early February of 2015."

Fitch Ratings says that, "the failure of Congress to renew government-sponsored terrorism reinsurance could have repercussions for the insurance industry and segments of the broader economy, particularly commercial real estate, mortgage lending and construction markets in 2015." According to Fitch, "TRIPRA is an important component of the CMBS market and has become common in many transactions. If it is not renewed, we identify approximately 20 Fitch-rated transactions that would be put on Rating Watch Negative. As loan documents require terrorism insurance over the life of the loan, CMBS servicers may increasingly force-place coverage from their own carriers. This would likely be at a very high cost if coverage can be found at all." Fitch goes on to note that, "While there is a chance for legislative action in early 2015, insurers must prepare for managing risk exposures without the terrorism coverage that has been in place in various forms since 2002."

ISO/AAIS

Over the course of the past year many carriers have included conditional exclusions in their policies as provided by insurance standard setting bodies in the event that TRIA was not extended. Last week, the Insurance Services Office (ISO) announced that the termination of the Terrorism Risk Insurance Program will activate ISO's conditional commercial policy contract language to address terrorism coverage. According to ISO, "the terms of ISO's conditional terrorism endorsements will become applicable on January 1, 2015, to policies where they are attached and would apply to any losses that occur on or after that date. The conditional endorsements, first introduced in 2004, have been available not only for use with those policies issued earlier this year and that extend beyond TRIA's scheduled expiration but also for policies with inception dates beginning in 2015. The array of endorsements provides ISO participating insurers with several options, including: an exclusion for losses from acts of terrorism, an exclusion for losses from acts involving nuclear, biological, or chemical terrorism, and a means to cover terrorism losses not otherwise excluded up to a sublimit. ISO's conditional terrorism endorsements are available for use by participating insurers in all states except Florida and New York. In addition, ISO's manuals contain pricing information applicable to a post-TRIA environment."

With the pending expiration of the program, the American Association of Insurance Services (AAIS) informed its member companies that they have access to two types of endorsements they can use to address terrorism exposure. AAIS said, "For policies that take effect before Dec. 31, affiliates can still use "certified" terrorism coverage endorsements to meet their obligation to make such coverage available through Dec. 31. They can also add a "conditional" terrorism exclusion, where permitted, to exclude terrorism coverage as soon as the program expires. For policies issued after Dec. 31, affiliates can attach endorsements in most states that would exclude loss caused by terrorism as defined in the endorsements."

Broader Economic Impact

In addition to the impact on the insurance marketplace, the prolonged expiration of the program could also have a significant impact on the nation's economy as a whole. This impact is expected to be felt first in the commercial mortgage backed securities market. From there the ripple effect could expand more broadly into various industries. According to Jeffrey D. DeBoer, president and CEO of the Real Estate Roundtable, "Without TRIA, a large number of commercial real estate projects around the country will now fail to get financing, leading to cancellations, job losses and lost tax revenue at the local level. This credit issue will only increase in time as more transactions come to market." Fitch ratings agrees noting, "The failure of Congress to renew government-sponsored terrorism reinsurance could have repercussions for the insurance industry and segments of the broader economy, particularly commercial real estate, mortgage lending and construction markets in 2015."