



GC in the News

January 2003

Attempting the Impossible

Now that the Terrorism Risk Insurance Act is in place the insurance industry is being forced to do what many people have said is impossible: price terrorism risk. But finding the right price could be the difference between the Act's success and its failure.

By Ben Dyson

Reactions

"It's going to be a crap-shoot," says Klaus Gebhardt, senior vice-president in the property division at Ace Bermuda Insurance. He is describing the challenge of pricing terrorism risk now facing the US commercial property/casualty insurance industry. He believes that given the lack of data insurers have to price the risk, a lot will be left to chance. He says the prices being charged for cover under the new Terrorism Risk Insurance Act vary by as much as 1000%. "If there is such a variation in quotes it shows there is no underlying data for pricing the risk," says Gebhardt.

Others believe pricing terrorism risk is virtually impossible. "There is a line. On one side is risk that can be reasonably priced. We would put terrorism risk on the other side of the line," says Stephen Dreyer, an analyst at rating agency Standard & Poor's (S&P).

But pricing terrorism risk is exactly what US insurers must now do. And they do not have much time to do it. The new law has granted insurers 90 days to submit quotes for terrorism insurance to their policyholders. Policyholders then have a further 30 days to decide whether the quote is acceptable or not. Until that time, they are exposed to terrorism risk. The longer insurers wait before submitting their quotes, the longer they are providing terrorism cover for free. The race is on.

Mathematics and guesswork

The three big risk modelling agencies, AIR Worldwide, Eqecat and Risk Management Solutions (RMS), have all produced terrorism models to help insurers price the risk. But although the models are expected to make this onerous task a little easier, they will not completely remove the guesswork, say some observers.

"Most commercial insurers have acquainted themselves with first-generation terrorism models," says Bob Hartwig, chief economist at the Insurance Information Institute (III) in New York. "But the pricing process is going to be part mathematics and part judgment. They [insurers] can run scenarios and talk to experts but in the end a great deal of judgment will be involved."

And although terrorism models are available, there is no way of knowing how accurate they are. Catastrophe models, their closest relations in the risk-modelling world, have not always been successful. And because another terrorism event has yet to hit the US, the models remain untested. "We learned after Hurricane Andrew that the best catastrophe models in the market were completely wrong," says Julie Rochman, senior vice-president for public affairs at the American Insurance Association (AIA).

But getting the price right could determine the success of the new terrorism bill. If insurers price the risk too highly, policyholders may not be able to afford the cover and they will reject it. The intention of the bill was to create a bigger, more affordable terrorism insurance market. But this may not happen if too many wary insurers price the cover out of their clients' reach. Equally, given the heavy losses that can arise from insuring terrorism, this is one risk the insurance industry cannot afford to underprice.

There have already been some horror stories circulating the market about the kinds of prices that will be charged for terrorism cover. Some news reports have suggested that for landmark buildings - deemed the most likely targets of future September 11-style attacks - policyholders could be asked to pay as much for terrorism cover alone as they are already paying for the rest of their all-risk policy. This would double their existing insurance bill.

It is unlikely that risk managers will accept this kind of price. "There is some opinion that the value of risk is much higher than most buyers think it is," says Christopher Mandel, president of US risk managers' association Risk and Insurance Management Society (Rims), quoting the doubling in price some expect. "That is the way it has been priced since September II, which we vehemently think is overpriced."

Hartwig at III says he expects the coverage to be expensive and limited. "The price is likely to be high and insurers will be careful not to insure too much of this risk," he says. "Insurers need to be mindful of their fiduciary responsibility to 6m American businesses, not just to pay terrorism claims but also ordinary claims."

Others believe the prices vary greatly depending on the risk being covered and its location. "We have seen anything from between 2% and 3% of the all-risk premium to something higher in certain circumstances," says Suzanne Douglass, managing director of the property practice at broker Willis Risk Solutions in New York. She says that the higher prices were for buildings that could be potential targets. "At this point, there doesn't seem to be a whole lot of consistency in pricing," says Douglass. But she adds that only a short time has passed since the bill was signed.

But despite these concerns, some risk managers believe the prices they have been quoted so far have not been prohibitive. "The people I have spoken to say the response from the underwriting community has been pretty reasonable," says Mandel at Rims.

Others agree. "Our pricing for terrorism is around 6-7% of standard policy premium, which is very reassuring considering how high the pricing was for standalone terrorism coverage before TRIA's [the Terrorism Risk Insurance Act's] passage," says Wayne Salen, director of risk management for Niagara County.

But Salen adds that this might not be the case across the board. "It appears that one critical factor is who is pricing it," he says. "Some carriers are still in a scramble post-TRIA and their prices are still exceedingly high. I'm dealing with Allianz, Travelers and Chubb and they are all underwriting it at a reasonable price."

Forcing exclusions

There are also concerns that insurers, in a bid to restore the terrorism exclusions they lost when the Act was signed, will deliberately charge high rates for terrorism cover so their clients cannot afford it. If policyholders reject the quotes insurers provide, the Act allows the insurer to reinstate the exclusion that was on the policy before President Bush signed the Act. "I'm not going to name names but there is a risk that certain underwriters could use high prices as a way of avoiding the risk altogether or exploiting the market," says Mandel at Rims.

The Act tries to get around this problem by allowing state insurance regulators to step in when they feel insurers are being excessive or discriminatory in their terrorism pricing. But some observers are

unsure whether regulators would intervene in these cases. "My own view is that they won't," says Dreyer at S&P. "They take a hands-off approach to the commercial lines business. I would be very surprised if state regulators do step in."

Because of the limited data available, regulators are just as unsure as the companies themselves about what the right price for terrorism cover should be. They may not be confident enough in their own pricing ability to criticise insurers' attempts. "It is difficult for regulators to point to a model and say: 'The risk is x and you should price it no more than $x+y$,'" says James Eck, an analyst at rating agency Moody's. "It is more difficult than for natural catastrophes, where generally accepted risk models would be used to come up with a price. It will be interesting to see how much regulators get involved."

But others are confident that regulators will step in if they feel terrorism rates are excessive. Rochman at AIA says it is unlikely that companies will be allowed to price terrorism insurance excessively to avoid coverage. She points out that five US states -- California, Georgia, Texas, New York and Florida -- did not allow terrorism to be excluded in the first place. She adds that regulators are keeping a stern eye on insurance prices generally as a result of hardening rates in many lines of business.

Some believe many insurers are unlikely to risk incurring the wrath of state regulators. "Many companies are trying to develop pricing structures that will stand up to the scrutiny of the state regulators," says Douglass at Willis. "Many are trying to avoid [intervention from regulators] from the outset."

And although some companies may want to avoid writing terrorism risks, some believe others desperately want to offer coverage. Regulators prohibited the exclusion of certain risks, such as workers' compensation and so-called fire-following coverage. Some companies may now take the view that it is better to be paid to provide this coverage than risk giving it away for free. And so they are deliberately offering an attractive price for terrorism cover. "Some companies have told us they want to price it so they can sell it," says Douglass.

Insurers may also want to offer terrorism cover so they can be seen to be providing a comprehensive service to their clients. Some believe they run the risk of losing out to rivals that do write terrorism if they fail to cover the risk themselves.

"There may be some who charge deliberately high prices from the outset. But when they find it is a truly competitive disadvantage, they will stop doing that," says Douglass. She adds that even companies that are not required to offer the coverage want to. "Some companies have come to us and said they feel at a competitive disadvantage if they can't find a way to make this cover available," she says.

Companies that do try to charge high prices to force exclusions could find themselves in an awkward situation. Not only could they lose customers, but they could also risk looking like hypocrites. The insurance industry was one of the bill's most vociferous backers. Companies could look foolish if they refuse to support a bill they worked so hard to put in place. "The insurance industry lobbied for this support," says Douglass. "It would be politically very difficult for them if they were perceived not to be responding to the bill in the appropriate way." S&P's Dreyer agrees. "That would be a public relations nightmare," he says.

Getting it right first time

But insurers may unwittingly price themselves out of the market. Because they only have a short time to submit quotes to policyholders, and because terrorism risk is difficult to quantify, prices may tend to be on the high side. They have had little experience of pricing terrorism risk so it is unlikely that they will get it right the first time.

"No single insurer has got pricing right yet," says Douglass. She adds that pricing may have to be revised later. "We saw this even with the standalone policies," she says. "At first there wasn't an audience for the product because companies had priced it too high." But the companies gradually repriced this cover and attracted buyers eventually. "Maybe that kind of shake-out will happen here as well," says Douglass.

Although some observers expect prices to be high at first, they acknowledge that they will come down over time if there are no terrorist events. S&P's Dreyer says he expects some of the quotes to be "eye-popping", but he adds: "Initially the price will be high but how many terrorism-free months can we have before insurers feel they can go lower?"

And although some believe certain insurers may try to avoid covering terrorism risks, many feel that the passage of the Act will attract more players to write the business, though they are likely to be cautious at first. Insurers are required to retain losses equivalent to 7% of their direct written premiums in 2003. This will rise to 10% in 2004 and 15% in 2005. "There are a lot of companies who think the bill will allow them to do something they haven't done before," says Douglass. "But they are still a little shaky because it is a sizable retention, especially for the larger insurance groups."

Hartwig at III is less optimistic. Rather than attracting new players, he feels that only the insurers already covering terrorism will remain in place under the bill. "The initial effect will be that it will enable companies to feel like they don't have to leave the market," he says. "The bill allows them to determine their probable maximum loss. Before, they couldn't do that. This gives them the confidence to stay in the market."

He says the bill could eventually make the terrorism market attractive to new players. But he adds: "That's a big if. It depends on the level of risk -- real or perceived -- from a terrorist event. A war with Iraq would increase the risk of a terrorist attack."

The passage of the Terrorism Risk Insurance Act has thrown the industry into turmoil temporarily. But some feel that the results will be worth the effort. "In the longer term, the bill will be a good thing for the industry," says Douglass at Willis. "The market is being disrupted now, which you can understand if you look at the onus on the industry in terms of policyholder notifications. But it will have a positive effect. It will break a log-jam and a market will emerge from this that will help fulfill the intention of the Act."

The reinsurers' tale

How the Act affects the reinsurance industry

Reinsurers are not directly affected by the new Terrorism Risk Insurance Act. The Act does not dictate that they should offer terrorism cover to cedants. Nor do they stand to benefit from any government help in the event of large terrorism losses.

Nevertheless reinsurers could play an important role in the success of the Act. Many feel insurers' retention levels under the Act are very high. And on top of the retention, insurers are

required to saddle 10% of all losses up to a maximum of \$100bn. Some may try to avoid providing terrorism coverage because they feel they cannot afford to take on that much risk. But if they could get reinsurance to help them carry this burden, they may be more willing to participate.

The bill could prompt more reinsurers to offer terrorism risk. The Act puts in place a loss cap that was not there before, meaning reinsurers writing terrorism risk will not be liable for an unknown amount of terrorism risk. But because they will not benefit from the bill, some believe reinsurers may be reluctant to participate in what is still essentially an unquantifiable risk.

"To the extent the bill reduces some uncertainty about the size of the losses it does help," says Bob Hartwig, chief economist at the Insurance Information Institute. "But the economic incentive for

reinsurers to cover terrorism in a material way is less than for primary insurers because they do not benefit from the bill directly."

Matt Moser, head of the domestic US property/casualty division at rating agency AM Best, agrees. "The level of information and comfort about terrorism exposures makes it unlikely that the reinsurance industry as a whole will get comfortable with writing these risks on a large-scale basis."

Reinsurers also face the same challenges as insurers in trying to price the risk. There is little data available and so reinsurers, like their primary counterparts, may have to resort to guesswork. Many feel that reinsurers would prefer to err on the side of caution and will slap a hefty premium in terrorism coverage.

"In general, capacity is available but expensive," says Rod Fox, chief executive officer of US reinsurance broker Benfield Blanch. He says the rate on line -- premiums as a percentage of the coverage amount -- for reinsurance below the bill's retention level is between 20% and 25%.

Sean Mooney, chief economist at rival reinsurance broker Guy Carpenter, says rates on line for reinsurance below the retention level are bound to be higher than standard coverage. "The pricing is for lower layers -- the very initial layers where you have more frequency," he explains. "By definition the rate on line is going to be higher than you would normally charge. You can equate it to writing wind as opposed to hurricane reinsurance."

The reinsurance available is also likely to offer broader coverage than the bill stipulates. "The bill covers foreign terrorism. But a lot of the quotes we expect will cover foreign and domestic terrorism," says Mooney.

Nevertheless, some companies may find rates too expensive. Klaus Gebhardt, senior vice-president in the property division at Ace Bermuda Insurance, says he has been shopping around for terrorism reinsurance for his property portfolio. "What I am finding is that although some coverage might be available, the cost is so prohibitive that it makes no sense to buy it," he says. "The minimum rate on line for catastrophic terrorism cover is 20%." This means \$100m of terrorism reinsurance would cost \$20m. "It would take about two property policies to use up \$100m in a particular area," he says.

Fox says there are ways to reduce the cost of reinsurance coverage. He says one option is to structure a reinsurance programme so it only covers certain metropolitan areas rather than the whole of the US. Another option could be to buy coverage without protection to nuclear, biological and chemical attacks. Fox says reinsurance that includes these risks is the most expensive.

As well as charging high prices, reinsurers are also likely to offer limited coverage. Fox estimates that global capacity for all terrorism risks except nuclear, biological and chemical attacks could be \$700m. This figure could be even higher for individual lines, such as property or workers' compensation. But he says capacity covering all lines including nuclear, biological and chemical attacks could be between \$350m and \$400m.

Mooney at Guy Carpenter is more optimistic. He says that according to a survey carried out by his company, the insurance industry needs \$5bn in terrorism reinsurance, and that there is about \$3.5bn in capacity. He adds that he expects the \$1.5bn shortfall will be made up.

Capacity is limited and prices are high, but this could soon change. "We think prices will come down and more capacity will become available," says Fox. He also believes that the terrorism bill has helped. "More reinsurers are willing to offer coverage than before the bill was passed," he says. "This will increase over time."

But some risks will always be difficult to place. "I would expect there will be capacity for risks in non-urban areas or risks that are not significant. But there will still be problems for high-value property or

where there are high concentrations of people," says Franklin Nutter, president of the Reinsurance Association of America.

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