Legal Backgrounder

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FEDERAL ROLE ESSENTIAL FOR TERRORISM RISK INSURANCE

By

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On December 31, 2005, the Terrorism Risk Insurance Act, or TRIA, is set to expire. Congress passed TRIA to provide a federal financial backstop for insurers for some insurance claims resulting from certain terrorist attacks. The debate over whether to extend it has been contentious, with many voices making their opinion known, including the Department of Treasury which, through a long-anticipated report stated that while the federal government should maintain some role in terrorism insurance, it should be a lesser role than TRIA dictates. This LEGAL BACKGROUNDER argues that significant federal involvement in terrorism insurance remains imperative, and explains why TRIA's demise will profoundly, and uniquely, affect those companies who offer worker's compensation.

MEMIC. My company, MEMIC, is not a state fund but rather a Maine domestic mutual insurer authorized by Maine state law to write Workers' Compensation insurance. MEMIC was created by the Maine Legislature in 1992 as part of Maine's Workers' Compensation reforms. Before 1992, Maine employers paid among the highest insurance premiums in the country, while receiving average service at best from insurers operating involuntarily in the state's assigned risk pool. Like the pool, MEMIC is the market of last resort and *must* insure all employers that seek coverage. MEMIC now insures some 65 percent of the insured market, or 22,000 employers and an estimated 200,000 Maine workers. Unlike the pool, MEMIC has invested heavily in loss control, injury prevention, and return to work programs. As a result, the State of Maine has seen both insurance rates and the frequency of lost time claims decline by some 30 percent over the past 12 years. During this time, MEMIC has also been able to return to its Maine policyholders more than $50 million in capital investments and dividends.

This company has experienced tremendous growth during the past seven years and now writes approximately $160 million in premiums in Maine alone. Recognizing that this single state company was particularly susceptible to potential problems associated with excessive concentration of risk, MEMIC created a subsidiary licensed in New Hampshire known as MEMIC Indemnity Company (MIC). Like MEMIC, MIC's unique dedication to safety in the workplace and its specialization as a Workers' Compensation carrier quickly caught the attention of policyholders and independent insurance agents throughout New Hampshire. In four years, MIC has grown to be the fourth largest comp carrier in that state,

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and includes the entire University of New Hampshire system among its insureds. Further, MIC has now become licensed in Connecticut, Massachusetts, Vermont, New York, Pennsylvania, and New Hampshire, with license applications pending in all other states along the eastern seaboard.

The Local Nature of the Workers' Compensation Market. MEMIC's ability to withstand a catastrophic loss such as a terrorist attack differs from that of other insurers. Those insurers are larger, better capitalized, able to choose the risks they want to write, and able to diversify by writing many lines of commercial insurance across multiple states, if not countries. They are better able to spread a small part of a very large loss across a correspondingly larger risk pool, even though the terrorism exposure is potentially too large for any single insurance company to assume. However, MEMIC is like hundreds of smaller insurance companies that specialize in a single line of insurance or operate in a single state or specific region. Moreover, like every insurance company in the United States that writes workers' compensation policies, MEMIC is required by state law to include coverage for risk related to terrorism.

For workers' compensation, a single private mutual insurance company or a state fund handles the bulk of insurance coverage for businesses in 27 states. Many of these companies, often characterized as guaranteed markets, must accept all applicants. While most large multiline commercial insurers may limit the scope or aggregation of risks that they are willing to cover in a specific area, MEMIC and many other private mutuals or state funds find themselves with tremendous concentration of risk. This concentration of risk is best exemplified by the California State Fund, which is the single largest writer of comp business in the U.S. despite the fact it only operates in California. Another example of the concentration that is pervasive throughout this country is Beacon Mutual, which writes nearly three-fourths of all commercial Workers' Compensation business in Rhode Island. A handful of states have a monopolistic environment in which a single company handles all the Workers' Compensation business written in that state. Like MEMIC, these companies specialize in Workers' Compensation only, and operate in a smaller geographic area than the nationally recognized companies that come to mind when one refers to "the insurance industry."

State laws prohibit Workers' Compensation policies from excluding terror-related losses, thus leaving many regional Workers' Compensation specialists in an extremely vulnerable position. Many have a high concentration of risk, a mandate to take all comers, and an inability to exclude terror-related occurrences that are capable of rendering catastrophic levels of human and economic devastation in particular areas or regions. Everyone recognizes that terrorism knows no boundaries and follows no rules.

The Impossibility of Pricing Terrorism Risk in a Local Market. If TRIA lapses, it is certain that reinsurance without a terrorism exclusion will either be completely unavailable or prohibitively expensive for companies like MEMIC. One often reads about the billions of dollars supporting the insurance industry and how that may be enough to cover the impact of a terrorist attack in the future. Ironically, that surplus is not available to my company or any other company that suffers the misfortune of assuming risk and finding itself doing business in the wrong place at the wrong time. Instead, MEMIC must rely exclusively on its own surplus, approximately $155 million, and is not party to a guaranty fund or any other mechanism designed to help in the aftermath of a disaster. Like many other insurance companies, we are an "assessable" mutual, which means we would be forced to collect additional premiums after the fact from the very businesses that were directly targeted in the attack.

Maine shares 611 miles of porous border with Canada and 3,500 miles of coastline. While some may consider Maine an unlikely venue for such an attack, we have our share of appealing targets with easy access given the geography of our state. The first target might be Portland, the largest commercial seaport in New England and a major delivery center for Middle Eastern oil as well as the terminus for a natural gas pipeline. Additional targets might include the port area with visiting cruise ships, Bath Iron Works, the Portsmouth Naval Shipyard or Kennebunkport, a summer home for two U.S. Presidents.

MEMIC prides itself on its attention to accident prevention and loss control. However, whether a particular site becomes the target of a terrorist attack has nothing to do with local loss control or return-to-work plans or any other risk mitigation effort that our company might conceivably undertake. While the threat of a terrorist attack is a national concern, the impact is likely to be concentrated on a particular area

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selected by the attackers. TRIA enables companies like MEMIC to continue to assume risk emanating from the threat of terrorism that would otherwise force insurance companies to either reduce their exposure to terrorism-related risk, or cease providing such coverage altogether.

What Would the Expiration of TRIA Mean to MIC and MEMIC? I have given much thought to how MEMIC would respond if TRIA lapses. First, I would recommend to my Board of Directors that MIC cease writing business, as the capitalization of that company is too small to even consider undertaking such enormous risk without the protection of reinsurance or the protection afforded by TRIA. MIC's capitalization originated from its parent, MEMIC, and we simply could not jeopardize the financial security of MEMIC, let alone the solvency of MIC. I would not want to risk MEMIC capital on the hope that there will not be a terrorist strike against a target located in New Hampshire, Connecticut, New York, or any of the other states where we provide coverage for businesses and their workers.

Unlike MIC, MEMIC is required to write business in Maine and currently handles two-thirds of the insured market. While we would continue to operate with our proverbial "fingers crossed," our market share would probably move toward 100 percent as other writers of this line exit from the area of incalculable risk. Inevitably, the Maine economy would immediately feel the impact of this shift; service levels would be negatively affected, and the price of our policies would increase as we attempt to establish a reserve to fund even part of a potential loss.

What Would a Terrorist Strike Mean to MEMIC and Insurers Like It? A death claim in Maine can result in dependency payments of 500 weeks and then even longer if minor children are involved. While some death cases result in losses of $500,000, the average is actually closer to $200,000 each. Of course, permanent incapacity cases are far more expensive because they may result in lifetime indemnity benefits and very expensive medical care. Assuming an average loss of $200,000 per claim, an attack claiming 500 deaths could easily impact MEMIC by $100 million. If an explosion resulted in 1,000 deaths, the figure would be $200 million. If a "dirty bomb" resulted in 2,000 deaths, the exposure to MEMIC would be $400 million, and these figures don't even include consideration for the injuries and permanent impairments that would also be involved.

To put this in perspective, consider that the $400 million figure is about one-fifth of the $2 billion in Workers' Compensation losses associated with 9/11. At present, with TRIA in place, MEMIC and MIC have been able to obtain reinsurance, but only for a band from $20 million to $50 million per occurrence. Prior to 9/11, MEMIC was able to purchase similar reinsurance with an attachment point at $500,000 to virtually no limit. Now, reinsurance is still available (at reduced coverage levels) essentially due to the fact that reinsurance companies are only picking up the exposure created by the deductible and coinsurance features of the TRIA program. In the absence of TRIA, the transfer of risk changes dramatically.

The chart below demonstrates the impact on MEMIC of a single catastrophic event. The first column shows the result "with" TRIA and second shows the result "without" TRIA.

	With TRIA	Without TRIA
Single Loss paid by MEMIC	**$190,000,000**	**$190,000,000**
Deductibles:		
15% of Direct Earned Premium ($160m)	$24,000,000	$0
Co-pay: 10% of $166,000	$16,600,000	$0
Recoveries from TRIA	$149,400,000	$0
Reinsurance Recoveries	$20,600,000	$30,000,000
Net Loss to MEMIC Policyholders from Surplus	$20,000,000	$160,000,000
Current Surplus	$160,000,000	$160,000,000
Post Event Surplus	**$140,000,000**	**$0**

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What this demonstrates is that a loss in excess of $190 million *without TRIA* would render MEMIC virtually insolvent. A loss amounting to less than $190 million could require MEMIC to impose substantial assessments on its policyholders in order to bring the surplus back to acceptable levels. MEMIC would have no choice but to assess the very same businesses that just suffered from the event that inflicted the loss.

Without TRIA, and the ability to spread this unique risk, a terrorist attack would result not just in hundreds or thousands of deaths or injuries, but potentially in the economic devastation of selected insurer(s) and surviving businesses in affected areas. Perhaps the "unlucky" company will be the Maryland State Fund and, by extension, the thousands of businesses that currently rely on it for coverage.

In considering how an act of terrorism would affect workers' comp — or any other line of property-casualty insurance, for that matter—it is important to understand the unique nature of terrorism-related risk. Terrorism is fundamentally different from other types of insurable risks — different even from major catastrophes such as hurricanes and earthquakes. As costly as natural disasters can be, insurers at least have the ability to predict the long-term frequency, magnitude, and location of such events. Historical data combined with sophisticated forecasting models have given insurers the ability to assess natural disaster risk with enough accuracy to determine how much to charge for coverage, and how much risk exposure they can assume relative to their capacity to pay claims if a major event were to occur.

Terrorism, on the other hand, does not conform to cyclical weather patterns, and is not confined to particular geographic regions. Because terrorist acts are planned and carried out by human agents, their frequency and location are impossible to predict. It is a fundamental tenet of insurance that if a risk cannot be accurately assessed, no basis exists for establishing the price of coverage. Nevertheless, states laws frequently mandate what types of losses must be covered and what rates can be charged. In the case of Workers' Compensation insurance, every state requires carriers to cover the risks associated with terrorism.

Those who oppose TRIA extension apparently believe that in the absence of government intervention, "the market" will solve the problem of terrorism risk management. This view fails to recognize that the market for workers' compensation insurance — and for most other lines of insurance as well — is already heavily burdened by government intervention. Unfortunately, there is no such thing as a "free market" when it comes to insurance. After all, when insurers are mandated by law to offer particular products — often at a below-market prices — one can hardly expect the laws of supply and demand to operate normally. Under these circumstances, if TRIA is not extended, prudent insurers — especially workers' compensation writers — may well decide to cease offering coverage.

Conclusions. Before 9/11, workers' compensation insurers could count on adequate reinsurance being available from private reinsurance companies around the world. However, the ability of reinsurers to accept the transfer of risk from companies like MEMIC ended abruptly after the horrific attack on the World Trade Center.

The events of 9/11 affected many, if not all, of the world's largest insurance companies, both primary insurers and reinsurers. Yet no segment of the industry suffered greater losses, proportionally, than the workers' compensation companies. If anything, the vulnerability of workers' compensation companies has only increased since September 11, 2001. We have large concentrations of risk, are prevented by the laws in every state from excluding acts of terrorism, and are unable to purchase adequate reinsurance to avoid a financial calamity.

Unless the TRIA program is extended, the magnitude of potential losses resulting from a terrorist attack will simply be too great for any workers' compensation company to absorb. Without TRIA, my recommendation to cease writing workers' compensation in MIC (and to write with "fingers crossed" in MEMIC) will no doubt be joined by CEOs throughout this industry.

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