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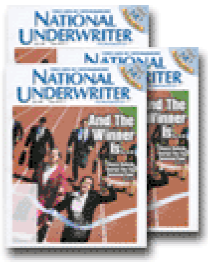

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NATIONAL UNDERWRITER
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Terrorism Cover: An Axis Of Uncertainty

By

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The insurance crisis that many observers expected in 2002 due to fallout from the Sept. 11 terrorist attacks looked like Y2K--lots of worry and little disruption. Unlike Y2K, however, the terrorist problem did not disappear when the electricity stayed on at midnight on New Year's Eve. Our society remains on a war footing with unprecedented attention to physical security, but it seems to have hit the snooze button regarding economic security.

Consumers, businesses and insurers are at least as vulnerable to terrorist threats as they are to natural disasters. Terrorist madmen can wreak havoc and generate losses even greater than those experienced on Sept. 11.

Contrary to common perceptions, the problem is not limited to "marquee" targets such as sports stadiums and skyscrapers. Consider the potential insured losses if a biological agent were released in a major metropolitan area that rendered hundreds of thousands of structures uninhabitable and led to widespread injuries.

Despite this, Congress has failed to enact terrorism legislation, regulators have resisted or rejected terrorism exclusions, and primary insurers have seemingly continued business as usual. As an actuary practicing in Florida, it seems eerily like 1992--while memories of Hurricane Hugo were still vivid, we were blindsided by Hurricane Andrew.

The fact that insurers have not yet precipitated an economic meltdown by unilaterally excluding coverage or non-renewing policies should not be taken as evidence that a problem does not exist. Instead, it likely reflects insurers' short-term desire not to disrupt relationships with customers in the hope that some workable solution can be found, as has occurred in other countries facing the type of threats we now do.

Reinsurers, however, have taken forceful action. Since their contracts are unregulated, they have had the freedom to act in ways unavailable to primary insurers. Generally, in commercial lines terrorism has been totally excluded, and in personal lines terrorism has been excluded for nuclear, biological and chemical losses.

Thus, many primary insurers are caught between the rock of regulated mandates to offer coverage and the hard place of unavailable reinsurance protection. Even where coverage exclusions have been allowed, the problem has just been shifted to policyholders, who face uninsured losses. This will increase the default risk on loans or make investors reluctant to underwrite major projects, creating a drag on economic activity.

Lost in the heated debate over whether regulators should allow terrorism exclusions in insurance contracts is a simple question: If insurers are barred from excluding the coverage, can they develop a way to price expected losses and estimate the exposure to their capital base from terrorist events?

Despite what many seem to believe, insurance is not welfare. Private-sector coverage cannot simply be given away because insurers have a lot of money (capital) and consumers need coverage.

Private-sector insurance is founded on the premise that an insurer collects a premium to cover *future* expected losses, transferring the risk from the policyholder to a larger pool of risks. If future losses are uncertain, insurers must collect additional premiums, because any losses not funded from premiums must be covered by insurer capital, and investors in insurance companies will not risk that capital without a return reflecting *future* risk.

Terrorism poses three problems that together create an actuarial axis of uncertainty:

• First, there is no credible historical data on terrorism losses.

• Second, lacking data, we cannot model the acts of madmen with any degree of certainty.

• Third, the size of the potential losses is so great that they cannot be absorbed in the premium base as a "contingency" without a "risk load" that could render the coverage unaffordable.

It is reasonable to ask why terrorism is different from other insured perils that are unusual, intentional or catastrophic. Examples of unusual exposures include policies issued on satellites and on college athletes. An example of an intentional act is common crime. Examples of catastrophes caused by an aggregation of many separate policy contracts might be found in earthquake and hurricane coverage. What makes terrorism different?

Consider the problem posed by insuring against a biological attack under personal lines policies. This is similar to nuclear risk, which has traditionally been excluded. The problem is not with insuring one nuclear power plant (where there is an aggregate limit on losses, which can be priced with some frequency/severity/risk assumptions), but with the issuance of millions of independent limits on homes that can "stack" to create losses far beyond what can be reasonably estimated. This is exactly what caused much of the problem on Sept.

One might even be able to write a biological liability policy on Al-Qaeda attacks, given a fixed limit. One could estimate the probability they would create a loss, assume how bad it could be, and price the exposure (probably at policy limits, but that is not the point).

The problem lies in pricing the effect of Al-Queda's actions on millions of policies with no historical data, no way to model it and the potential of a huge loss. Such a loss could not be absorbed as "noise" in "normal" losses, as is commonly done with new exposures such as property coverage on new types of computer equipment.

Contrast this to the intentional act of common crime. We have lots of crimes, a long history of criminal activity, and some reasonable way to estimate maximum losses. A gang of criminals cannot generate a $100 billion loss by stealing TV sets.

So we have the requisite conditions for an actuarial estimate of loss: millions of independent criminals acting in a manner reasonably consistent with their past patterns of deviant behavior, a probable maximum loss that is small on individual events, and individual events that are largely uncorrelated. None of these conditions exist with terrorism.

Thus, the "axis of uncertainty" makes it virtually impossible for terrorism to be insured in the private sector, unless the government mitigates the problem by reducing terrorist threats through heightened security or enacts some program to absorb large losses.

The current situation is unsustainable, because the threat is so large and difficult to quantify. Something has to give, and the only question in my mind is whether action will be taken before the next event, when solutions can be developed more deliberatively, or afterwards, when chaos reigns.

In Hurricane Andrew, Florida learned the hard way what happens when society hits the snooze button after a loud wakeup call. Hopefully, we will not make the same mistake on a national scale with the funding of terrorism losses.

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