RISKY BUSINESS

WISCONSIN'S INSURANCE INDUSTRY POST-SEPTEMBER 11

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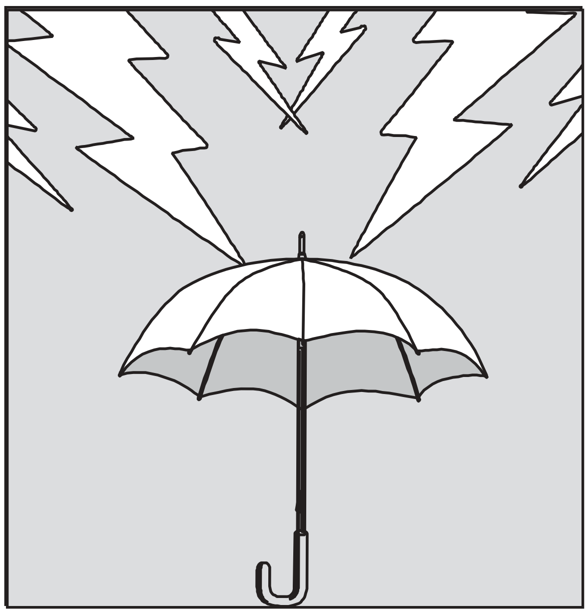

The terrorist attack of September 11 has created psychological and economic ripples throughout the world. Most notably to date in Wisconsin, as elsewhere in the United States, fear created by the attacks has led to a significant drop in travel, which continues today. The media reports that family gatherings were less well attended this Thanksgiving. Tourism has suffered badly in Florida. That tourism will be down during next summer's tourist season in Wisconsin is a distinct possibility.

Close to home, recreational activities, such as attending sporting events and going to the movies, have similarly felt the effects of the September 11 terrorist attack. The Green Bay Packers, as well as the rest of the National Football League, did not play the weekend following the attack. (Nor did the Milwaukee Brewers or the Wisconsin Badgers.) At the University of Wisconsin, security has been tightened for all future athletic contests. Officials have placed concrete blocks around Camp Randall Stadium and the Kohl Center and increased the number of security guards working at games. The university's anticipated expense for providing increased security at athletic events is approximately $200,000 for the current year.

Few businesses have been unscathed by the terrorist attacks and their aftermath. Risk management costs for almost all businesses have been or will be affected by the terrorist strike. Many Wisconsin businesses have incurred expenses to enhance security for their employees and their fixed location assets. Other businesses, which rely on direct mail campaigns to advertise their products, have been forced to revise their marketing strategies following the anthrax attacks. A number of different organizations, including American Family Insurance Company in Madison and divisions of the Wisconsin state government, actually shut down due to anthrax scares.

Biological terrorism is an especially significant concern to the Wisconsin agricultural industry. The financial devastation that would be felt by both Wisconsin farmers and the state economy if there were an outbreak of Mad

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Cow Disease or hoof-and-mouth disease is great. In Great Britain this year, hoof-and-mouth disease led to the destruction of four million livestock. This amounts to a four billion dollar loss using a $1000 value per head of livestock. The loss to the tourism industry as a result of the disease was approximately 4.2 billion dollars. Arguably, biological terrorism directed at the agricultural industry is Wisconsin's biggest terrorist exposure.

But it is the insurance industry in Wisconsin that may experience the most dramatic changes and must confront some of the most difficult dilemmas of the age of terror.

Premiums for some lines of insurance have increased sharply. Commercial property premiums being quoted by some insurers are 30-60% higher than they were a year ago. The availability of some lines of insurance is greatly reduced. In some cases reinsurers providing catastrophic coverage for life insurers are deciding not to renew treaties covering multiple lives. Somewhat surprisingly, the insurance industry seems to have been caught largely unprepared for the terrorist-related losses of September 11. The significant changes in premium levels and coverage availability are the overt signs of the insurance industry preparing itself for possible future terrorist-related losses.

For the insurance industry, both in Wisconsin and internationally, the events of September 11 redefined the peril of terrorism. In two important ways the terrorist acts committed against the United States that day differed significantly from any terrorist act the insurance industry had earlier witnessed. First, the financial damage resulting from the act was truly catastrophic. While the full extent of the financial cost of September 11 is not yet known, experts predict that the amount will establish a new record as the largest single loss suffered by the insurance industry. Second, the act is not a stand alone event, such as the bombing of the federal building in Oklahoma City. In contrast, the act follows earlier incidents of destruction by the same terrorist group, al Qaeda. Further, it is widely believed that the perpetrators pose an ongoing threat to the safety of individuals and their property.

The difference in loss costs arising from the events of September 11 and those of earlier acts of terror is stark. Prior to the destruction of the World Trade Center (WTC), the most significant acts of terrorism to occur in the United States included the bombing of an academic building on the University of Wisconsin–Madison campus during the Vietnam War era, the destruction of the Oklahoma City federal building, and the car bombing of the World Trade Center in 1993. The costs of these acts, both in terms of dollars and lost lives, pales in comparison to the costs of September 11.

Perhaps more significantly for the insurance industry than even the potential costs of this new brand of terrorism is the expectation that terrorism will increase in frequency and severity. Terrorism in today's world is an ongoing effort by organizations of people aiming to achieve group objectives. These organizations spawn acts of terror. Individual losses are thus not distinct, one-time events, so much as part of an ongoing process. The events of September 11 are widely viewed as the opening shots in a potentially protracted war. In retrospect, the 1993 car bombing of the World Trade Center now appears to be the prelude to the current war. The likelihood of future acts of terrorism as this war is waged against the American public, and more broadly against the Western world, is believed to be great. The insurance industry faces the prospect of future multi-billion dollar losses, if it continues to do business as it did the morning of September 11.

Insurance is widely recognized as an inappropriate instrument for financing damages inflicted simultaneously on many different people. When insurance companies underwrite policies they attempt to create pools of homogenous, independent risks. The essence of insurance is that, through the application of the law of large numbers, insurance companies can predict fairly accurately the number of losses that will arise from a pool of similar risks. This ability of insurance companies to predict losses collapses when the risks are correlated rather than independent. When losses are correlated they are said to suffer from simultaneous destruction or contagion. Examples include losses arising from floods, earthquakes, and war. Prior to September 11, the insurance industry in the United States did not generally consider acts of terrorism to be on this list. Prior acts of terrorism in the United States inflicted damage on a relatively small number of insured risks, typically single buildings. The WTC bombing showed that terrorists are both willing and able to inflict damages on a widespread scale. In a single event, tens if not hundreds of insurance companies suffered workers compensation losses, automobile losses, business income interruption losses, and many other types of loss.

Insurers have traditionally attempted to avoid bearing the risks associated with simultaneous destruction arising from war by specifically excluding war-related losses from their insurance policies.[1] Arguably, the insurance carriers could have invoked the war exclusion clause that is found in most insurance policies to deny the payment of claims related to the events of September 11. While there are several different versions of the war exclusion clause currently written into policies, perhaps the most frequently used form of the war exclusion is found in the commercial property Insurance Services Office standardized insurance forms. This version states:

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> Exclusions: War and Military Action
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> (1) War, including undeclared or civil war;
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> (2) Warlike action by a military force, including action in hindering or defending against an actual or expected attack, by any government, sovereign or other authority using military personnel or other agents; or
>
> (3) Insurrection, rebellion, revolution, usurped power, or action taken by governmental authority in hindering or defending against any of these.

Whether or not this exclusion applies to the current situation seems to rest on the definition of the word "war." Legal cases have held that for the war exclusion to apply the hostilities that give rise to losses must be engaged in by sovereign entities. Some experts have argued that a further requirement is that there be declaration of war by at least one side of the conflict. While statements from American political leaders, as well as the actions of the United States military following the terrorist attack on the World Trade Center and Pentagon, indicate that the U.S. is now at war in Afghanistan, the war exclusion does not apply. Significantly, the U.S. has not made a formal declaration of war. Further, the losses of September 11 have not been ascribed to a foreign government, but rather have been attributed to al Qaeda.

If al Qaeda is the agent of a sovereign government, the possibility exists that the war exclusion clause would apply to the losses of September 11. Some argue that the Taliban government and al Qaeda are one and the same. Others contend that al Qaeda's actions against the United States were at the behest of the Iraqi government. If either hypothesis is true, the grounds on which an insurer could deny a September 11 claim would be much greater. With what is currently known, the exclusion does not apply. Worth noting is that whatever hope insurers may have had of invoking the war exclusion clause was dashed by regulatory authorities who insisted that the war risk exclusion not be used by insurers to deny the payment of claims.

1. A notable exception is that insurance coverage is usually available on ocean-going ships and aircraft during times of war.

While insurers write policies in such a way as to avoid covering acts of simultaneous destruction, their policy language failed them in this instance. Warren Buffet contends that the insurance industry made the error of providing coverage for the risk of terrorism while not collecting a premium to cover that risk. Certainly this mistake will not be repeated by the industry in the future. In order to avoid covering future terrorist acts, which clearly can result in simultaneous destruction, insurers may issue future policies with a terrorist exclusion.

Inserting a terrorist exclusion into insurance policies may be necessary for the viability of many lines of insurance coverage. Insurance companies are incapable of pricing the risks posed by terrorism. Neither the likelihood of another terrorist act occurring nor the amount of damage it would inflict can be predicted by insurers with any degree of accuracy. Further, as mentioned earlier, terrorist acts may give rise to simultaneous destruction thus undermining the pooling technique, which is the basis of the insurance business. The inability of the insurance industry to handle losses arising out of terrorism has been recognized by regulators and the public. A government mandate that insurers provide coverage of this peril could ultimately lead to the collapse of some insurance companies and the reduced availability of insurance. It is highly likely that a governmental program to cover losses arising from terrorism will be put into place.

Governments have a history of providing insurance coverage for losses not insurable through private markets. The United States operates a flood insurance program that provides coverage to many homeowners and businesses living in flood prone areas. Prior to the enactment of the National Flood Insurance Program there was little flood insurance sold to either businesses or individual homeowners. This created difficulties for families, businesses, and the federal government. Families and businesses located in flood plains have a more difficult time obtaining mortgages when they are unable to acquire insurance. The government found itself in the position of providing disaster assistance to individuals who did not have flood insurance coverage. The National Flood Insurance Program addressed these problems by making insurance coverage available to individuals living in areas complying with requirements established by the Army Corps of Engineers to mitigate flood damage. The federal government underwrites the National Flood Insurance Program. Private insurers are permitted to sell the coverage but the risks of loss are borne by the government. Other examples of governmental insurance programs in the U.S. include state beach programs, which provide coverage for shore properties against wind damage; FAIR plans, which provide property coverage in urban areas; and high-risk health insurance pools in some states.

There are lessons to be learned from the operation of these plans as the United States considers implementation of an insurance program to cover terrorist losses. An important criticism of the National Flood Insurance Program is that it does not provide coverage at a rate that properly reflects the risk. Critics of the program have pointed out that, by providing insurance coverage at a subsidized rate in some areas, the government is encouraging development in hazard-prone areas where it would be wiser to discourage it. A similar concern could be raised about a terrorist insurance program. If rates are not set accurately, the government may create subsidies that encourage people to expose themselves to risk. For instance, the terrorist insurance program, by providing comparatively low cost coverage for terrorist-related losses, may provide a financial incentive for the rebuilding of the World Trade Center when it may be safer to build different types of office and residential space. The form of the terrorist insurance program is not currently known so this is speculation.

While the primary purpose of a governmental insurance program is to provide indemnification to those who suffer losses, secondary reasons for the program may also exist. The FAIR plans, which were enacted following the urban riots of the 1960s, were in large part established to encourage small businesses not to flee downtown areas. A secondary purpose of a terrorist insurance program may be to assure the citizenry that the government is able to provide protection against the risks of terrorism. Other governments that have established programs to cover costs arising out of terrorism include Great Britain, South Africa, and Spain.

While there is a strong political push to have the federal government enact a program that would provide insurance coverage against acts of terrorism, legislators should carefully consider this proposal within the greater context of the role and limitations of government. For over twenty years there has been a call by some in the insurance industry for the government to develop insurance coverage for the potential losses posed by earthquakes. The federal government has not enacted an earthquake insurance program despite dire predictions that a massive earthquake in California could have repercussions as significant to the American economy as the Civil War. The federal government's decision to date not to provide insurance protection for this peril has placed the burden of crafting solutions to the financing of this risk in the marketplace.

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There are a variety of different ways in which the marketplace may respond if the government does not implement a terrorism insurance program. One possibility is that lenders would refuse to extend credit to businesses because loans on fixed location assets would be too risky without insurance protection. Lack of coverage against the risk of earthquake does not seem to have significantly stopped lenders from making loans in earthquake prone areas. Further, to date there is no governmental program providing insurance protection against terrorism and loans have continued to be made since September 11. Following the terrorist attacks, lenders likely have greater concern about making loans in some geographic areas and for some types of development. Their concern that terrorism will affect most loans for fixed location assets, however, is probably minimal. It is doubtful that lending practices for most types of development in Wisconsin will be greatly affected by whether or not the federal government enacts a terrorism insurance program.

Rather than elect to forego making future loans, lenders could increase interest rates on debt in order to cover the perceived cost of the higher default risk arising from the possibility of terrorist related losses. The loan market would determine the surcharge rate. This method of financing risk is analogous to bottomry bonds issued by lenders to sea captains during the Italian Renaissance. At that time lenders charged higher interest rates if they felt there was greater risk that a captain's ship would be lost at sea. Of course, given the nature of the terrorist risk, there is little information for lenders to rely on in developing appropriate interest rate surcharges. The setting of the rate surcharges would be dictated by the market's appetite for risk.

A third alternative to enacting a federally sponsored terrorism insurance pool is to instead have the government emphasize loss control activities. Much has been done in this regard. The actions of the United States military to destroy the al Qaeda network decrease the likelihood that that organization will be able to strike against the property and lives of American citizens. The takeover of airline security by the government enhances its ability to exercise control in airports and on airplanes. The enforcement of no-fly zones in the vicinity of nuclear reactors decreases the likelihood of an attack on a reactor. Money spent on loss control activities can substitute for money spent on insurance programs. Alternatively, the government could pursue both loss control activities and insurance coverage simultaneously, as appears likely.

Besides governmental loss control activities, private industry has also implemented many new or enhanced loss control practices since September 11. There are numerous examples. Many businesses more carefully monitor their employees. The procedures used in handling mail at many businesses have changed. There has been an increase in the use of security personnel.

In the absence of governmental insurance coverage, loss control activities should be expected to be instituted by businesses and individuals at risk of terrorist-related insurance losses. The country's experience with the earthquake peril is illustrative. Significant advancements in the design of buildings that are earthquake-resistant have been made over the last thirty years. Whether the same level of resources that have been devoted to these technologically innovative designs would have been expended had there been a federal government earthquake insurance pool in place is doubtful. Similarly, the concern exists that if the federal government institutes a terrorism insurance pool it may crowd out public and private investment in loss control activities.

Whether the federal government should adopt an insurance program to cover the losses arising from terrorism is a complex question. The insurance industry absorbed massive financial losses on September 11 and has stated clearly that it cannot continue to provide coverage for acts of terrorism. The losses that the insurance industry suffered have resulted in increases in premium levels and restrictions in the availability of coverage. Contrary to early fears following September 11, business activity has not shut down.

Whether or not the federal government enacts a terrorism insurance pool, the designers of the pool would be wise to keep in mind several lessons from the government's experience with other insurance pools. First, premiums for the coverage should reflect the risk. Flood insurance premiums have been heavily criticized at various times for subsidizing risk-taking behavior. Second, the insurance program should not crowd out incentives for investment in loss control. The lack of a federal earthquake insurance program has resulted in significant technological advances in the design of earthquake-resistant structures. Finally, it seems likely that if the government fails to establish a terrorism insurance pool, the market will develop methods for bearing the risk of future losses.