October 9, 2013

Future of TRIPRA Remains Uncertain, Rating Pressure Intensifies

Overreliance on TRIPRA no substitute for sound risk management.

Despite three separate proposals in the House of Representatives to extend the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA), there is no indication whether Congress will decide the act's future in the coming months. With TRIPRA set to expire Dec. 31, 2014, a key concern for A.M. Best is that insurers writing policies in the beginning of 2014 could potentially be exposed to terrorism risk after the end of the year.

As stated in an earlier Best's Briefing (*As Expiration of TRIPRA Approaches, Rating Pressure Increases* April 1, 2013), a federal backstop helps reduce the impact terrorism has on an organization's risk-adjusted capitalization, but overreliance on such a mechanism is not a substitute for sound risk management. A.M. Best continues to request that insurers, especially those heavily reliant on TRIPRA, present detailed plans to be implemented in the event the act is not renewed or its protection is materially reduced.

As part of the rating process, A.M. Best uses a stress test to assess the impact of a particular terrorism attack on an insurer's balance sheet. This is not intended to be a worst case scenario but rather a deterministic scenario simulating a conventional weapon attack (e.g., similar to a five- or six-ton TNT truck bomb, with no restrictions placed on the radius and assuming the attack occurs when the buildings are at their highest occupancy).

This deterministic estimate is requested in the Supplemental Rating Questionnaire (SRQ) annually, and is required for insurers with more than 10% of calendar year written premium (prior to reinsurance) derived from commercial lines coverages (other than commercial auto, professional liability, surety, farmowners, and burglary/theft). Insurers unable to provide this information are asked for loss estimates based on a maximum foreseeable loss scenario.

These estimates are used to stress an insurer's capitalization via Best's Capital Adequacy Ratio (BCAR) as if TRIPRA did not exist. A resulting pass or fail is determined based on these tests, as well as on the number of insured locations materially exposed to terrorism risk. (For more details, read the criteria report *The Treatment of Terrorism Risk in the Rating Evaluation*, which can be found at www.ambest.com.)

This year, A.M. Best determined that 226 property/casualty rating units, out of a total of 889, have terrorism loss estimates based on the above scenarios. A rating unit represents either a single operating company or several affiliated member companies that have common rating assignments due to common operations, internal pooling or reinsurance agreements. Of this population, 34 rating units (3.8% of the total) failed the stress test and were determined to be overreliant on TRIPRA.

Conversations with management of these affected rating units are ongoing, and A.M. Best is requiring that they present an action plan detailing the steps they will take to reduce concentration of exposure to terrorism risk, should TRIPRA protection change materially. By early December, if TRIPRA is not renewed or if its protection is materially

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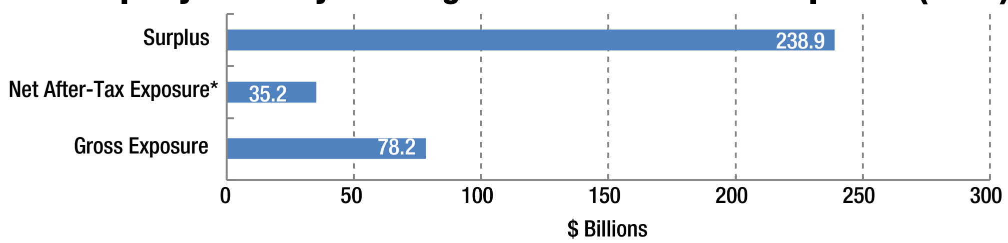
reduced, each rating unit that failed the stress test will be brought before a rating committee. If the action plan is insufficient, the rating unit will face negative rating pressure, most likely in the form of assigning a negative outlook. While private terrorism reinsurance is currently available, the future availability and affordability of this coverage, if the federal backstop is not renewed or changes significantly, is unknown. Furthermore, rating units with limited access to capital and/or concentrations of net losses that would result in a substantial loss to surplus, regardless of the locations, are of the greatest concern and are most likely to face this rating pressure.

As stated previously, there were 226 rating units (25.4% of the total number of rating units) that disclosed a material terrorism exposure. The combined surplus of the 226 rating units approximated $238.9 billion (see **Exhibit 1**), with an aggregate net after-tax exposure, excluding the benefit of TRIPRA, for each rating unit's largest potential loss based on the aforementioned terrorism attack scenarios of approximately $35 billion, resulting in an exposure-to-surplus ratio of 15%.

Exhibit 1

U.S. Property/Casualty – Rating Units with Terrorism Exposure (2013)



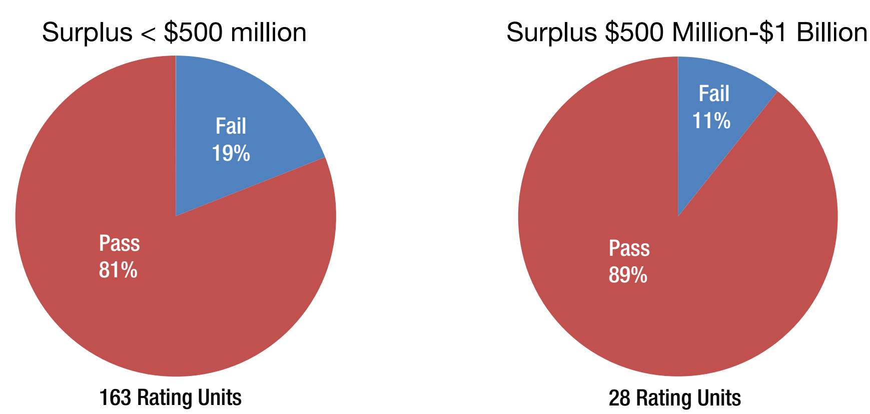
Note: There are 226 rating units deemed to have terrorism exposure based on A.M. Best criteria.
* Excludes the benefit of the Terrorism Risk Insurance Program Reauthorization Act.
Source: A.M. Best data and research

A correlation was found between the rating unit's surplus size and its rate of failure (see **Exhibit 2**). For example, 72% of the 226 rating units had statutory surplus of $500 million or less. This group had a failure rate of 19%. Twelve percent of the rating units had surplus between $500 million and $1 billion. The failure rate for this group decreased to 11%. The remaining rating units had surplus of $1 billion or more for which none failed the stress test.

Exhibit 2

U.S. Property/Casualty – Rating Unit Terrorism Exposure Based on Surplus Size (2013)

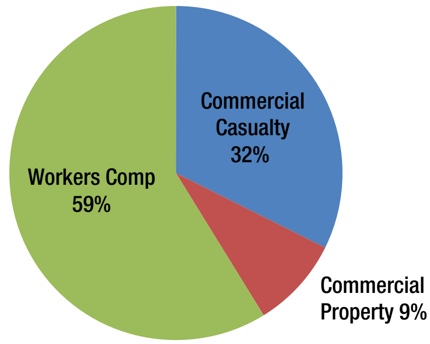
Pass/fail rate of stress test for rating units with less than $1 Billion in surplus deemed to have terrorism exposure under A.M. Best criteria.



Source: A.M. Best data and research

The entire population of 226 rating units spanned 10 different composites, however the rating units that failed the stress test were concentrated in the workers' compensation composite and the commercial casualty composite (see **Exhibit 3**). In addition, most of the modeled losses relating to the commercial casualty composite members consisted of workers' comp exposures as opposed to property exposures. This is of particular importance as terrorism protection is mandatory for most workers' comp products. This leaves rating units with large workers' comp terrorism risks even less options when contemplating how to reduce this exposure.

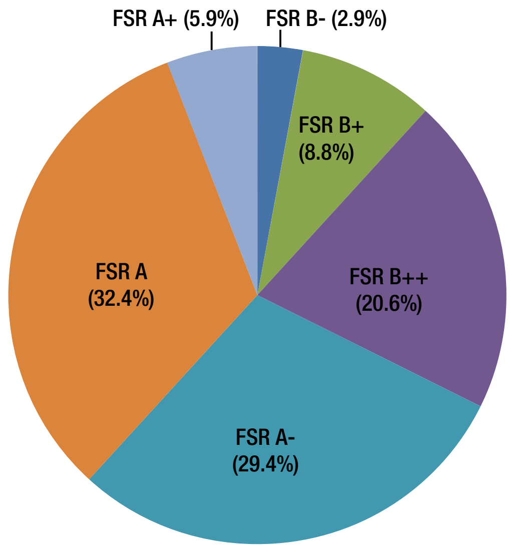
Exhibit 3
U.S. Property/Casualty – Composite of Rating Units That Failed Terrorism Stress Test (2013)



Note: Of the 226 rating units deemed to have terrorism exposure based on A.M. Best criteria, 34 failed a related stress test.
Source: A.M. Best data and research

The vast majority of rating units included in this analysis carried a secure Financial Strength Rating (FSR) of B+ or higher. The rating distribution of the rating units that failed the stress test is displayed in **Exhibit 4**.

Exhibit 4
U.S. Property/Casualty – Rating Distribution of Rating Units That Failed Terrorism Stress Test (2013)



Note: Of the 226 rating units deemed to have terrorism exposure based on A.M. Best criteria, 34 failed a related stress test.
Source: A.M. Best data and research

A relatively small percentage (3.8%) of all P/C rating units face negative rating pressure should TRIPRA not be renewed. However, this analysis was based on a single event using a specific attack scenario. Due to the potential for high severity, as well as the unconventional means in which a terrorist attack may be carried out, modeled results could vary substantially from actual losses.

The temporary nature of TRIPRA exemplifies why it is crucial for the financial strength of any insurer with a material exposure to terrorism risk to have a comprehensive risk management process. Data quality is of utmost importance when assessing the true exposure of an insured risk. Characteristics such as construction type, number of employees, number of building locations and ensuring an accurate address are just some characteristics that can have a drastic effect on the modeled results.

As Congress debates the future of TRIPRA, A.M. Best will continue to monitor the situation closely and provide updates as necessary. Rating actions on rating units that cannot adequately provide a credible plan to address the possibility of TRIPRA lapsing will occur in early December of this year, as insurers anticipate writing policies that are exposed to terrorism after TRIPRA's stated expiration.

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