

## **Terrorism Risk**

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“Insurance companies do not ‘take’ risks. They knowingly accept and mutualize risks” said Paul O’Neill, the Secretary of the US Treasury in October 2001. The advent of the September 11 2001 terrorist act had an adverse effect on the property and casualty insurance industry. The first effect was the introduction of the federal Terrorism Risk Insurance Act, which was signed into motion by President George. W. Bush on November 26 2002. The Act is intended as a short-term measure for insurance companies to find methods of ‘mutualizing’ terrorism risk. The Act provided reinsurance coverage for insurance companies for terrorism related catastrophes and is to expire on 31 December 2007 after a two-year extension in 2005.

The question for the insurance industry today is how do you account for terrorism risk? In comparison to other types of insurable risks like auto and property, the amount of data available on these occurrences is very limited. Terrorism risk is defined by the United Nations as the “peacetime equivalent of a war-crime” and in the same respect of war its effects are catastrophic. The occurrence of terrorism is sporadic and thus development methods to predict the losses are out of the question. One could design a framework around terrorism risk by analyzing the components of the risk in general, which are the threats, the vulnerabilities and the consequence aspect of terrorism.

Firstly, the threat aspect of terrorism involves the likelihood of the event happening. One could argue that high density areas, tourist spots and government buildings are considered as high target areas and a higher probability may be assigned to the threat aspect of terrorism. The probabilities assigned for a certain area or insurable interest will depend on its demographics, location, and also potential losses that may accrue from the damage.

Vulnerabilities, on the other hand, define the likelihood that the attack results in a damage given that an attack occurs. In a risk management framework, the probability associated with an insurable interest's vulnerabilities depends on how susceptible the place is to risk. Among the things that is taken into consideration are security and monitoring systems, emergency precautions taken and other measures taken to avert perils that come as a result of a terrorist act like fire, explosion and flood. In essence, if more steps are taken to prevent or mitigate the losses, the probability of a loss happening given a threat of loss is lessened.

The consequence aspect of terrorism encompasses the expected value for losses given that an attack occurs and the attack results in a damage. The amount of expected losses may include monetary damages, physical losses, deaths and other exposures subject to loss because of the terrorist act. Losses are catastrophic and indeed premiums will be high. The unpredictability of terrorist acts will also account for higher fixed and variable expenses for insurance companies.

In conclusion, after analyzing terrorism risk in a risk management framework, one can see that accounting for future disasters from terrorism will involve a lot of research in the probability aspects of threat and vulnerability. However, coming to a set number after doing the research will involve comparing many precedents and using a lot of judgment. The terrorism risk insurance market will definitely evolve in the coming years as the federal government lessens its role in reinsurance after the expiration of the Terrorism Risk Insurance Act at the end of 2007.