INFORMED BUDGETEER

After any disastrous event, there is immediately an intense, but often misguided, effort to affix a "final, total" cost figure to the event, with full recognition that the human cost of such tragedies can never be truly affixed. Certainly the final economic cost - to businesses, insurers, and governments - cannot be known for years until a whole sequence of complicated and interrelated events occurs: losses are claimed, insurers decide payments, lawsuits are litigated, settlements reached, and governments respond.

Nonetheless, it is natural for budgeteers to want to peg the federal government's share of costs from the attacks, even though that is unknowable at this time. So far, the Congress has enacted the $20 billion the President asked for, with the promise of another $20 billion, plus some amount in legislation for the airline industry. In previous (natural) disasters, the government's cost has been a function of the large extent of uninsured losses (earthquakes and floods). Ultimately, the federal costs of September 11 will depend on how insurance issues are resolved or litigated, and, to some extent, whether the courts view these events as part of a "war." This week's *Bulletin* (which owes a debt to the Congressional Research Service (CRS) for much of the background material) outlines some of those insurance questions as well as other legislation that responds to this tragedy.

COST OF THE WAR ON TERRORISM?

- It's way too early to know what the cost of Operation Infinite Justice will be, but a CRS report – *Cost of Major U.S. Wars* – outlines the approach used to measure the cost of U.S. overseas military operations and compares the cost of wars since World War I (shown in the table below). The approach measures such costs by determining the incremental expenses "over and above the ongoing costs of normal military operational tempo, training, pay", and investments.

COSTS OF MAJOR U.S. WARS
(Constant FY 2002 $ in Billions)

World War I	$ 577
World War II	$ 4,710
Korea	$ 400
Vietnam	$ 572
Persian Gulf War[a]	$ 80

Source: Congressional Research Service
a/ Most Persian Gulf War costs were offset by allied contributions or were absorbed by DoD. Net costs to U.S. taxpayers totaled $4.7 billion in current year dollars, or 7.7% of the total cost. Source: *Department of Defense Annual Report to Congress*, January. 1993.

AIR TRANSPORTATION SYSTEM STABILIZATION ACT

- On Friday, the House and Senate were scheduled to provide assistance to airlines in the wake of the terrorist attacks. All spending provisions in the bill are designated as an emergency, including direct spending authority for: $5 billion immediate cash assistance to carriers and $10 billion for loan instruments, "subject to such terms and conditions as the President deems necessary" (advised by a new board that will review applications).

- Regarding retrospective liability and victim compensation, the bill limits carriers' liability to the amount of their insurance. The bill defines the universe of claimants as "any individual killed or physically injured as a result of the terrorist-related aircraft crashes of September 11, 2001" or a relative of a deceased individual.

- Under the bill, a claimant has two options. **(1)** Sue in federal court, with all cases consolidated in the Southern District of NY. The federal government has no financial obligation to indemnify or otherwise compensate plaintiffs in these actions against carriers or other defendants. **(2)** Apply for relief from a new federal government fund (cost estimate not yet available). A Special Master will determine compensation for the claimant, after taking into account other sources of compensation to that victim (i.e., insurance, employer payments, payments from a private relief fund). No punitive damages may be awarded by the Special Master.

- Although carriers' insurance policies had included coverage for acts of terrorism, the cost of those policies is now rising. To address carriers' liability in the future, the bill authorizes reimbursement (out of the war risk insurance fund, but no cost estimate is yet available) of an air carrier for the increase in the cost of insurance. Further, "[f]or acts of terrorism committed on or to an air carrier during the 180-day period following the date of enactment, the Secretary of Transportation may certify that the air carrier was a victim of an act of terrorism ... and [the air carrier] shall not be responsible for losses by third parties that exceed $100 million in the aggregate, for all claims arising out of such act, ... and the government shall be responsible for any liability above such amount. No punitive damages may be awarded against an air carrier under a cause of action arising out of such act."

PROPERTY INSURANCE COVERAGE AND THE WORLD TRADE CENTER

What is Commercial Property Insurance?

- To make sense of the insurance picture for the World Trade Center (WTC), CRS has provided a general review of commercial property insurance.

- A commercial property insurance policy can insure three separate types of property. The first type of policy is held by the **building owner**, insuring the building itself, including machinery, fixtures, and equipment that are permanently part of the building. The second type of policy is for the **personal property** (computers, phones) owned by the insured business (both the landlord and tenant business may purchase this type of policy). The third is the **personal property of others** (e.g. employees' personal books, computers) in the care, custody and control of the insured business or landlord.

- Coverage for commercial property insurance can be written on an actual cash value or replacement cost basis, the same as your homeowner's or renter's insurance. According to CRS, under an actual cash value policy the policyholder is entitled to receive an amount equal to the replacement value of damaged property minus an allowance for depreciation. A replacement cost insurance policy, on the other hand, pays the dollar amount needed to replace damaged personal property with new items of like kind and quality, without deducting for depreciation.

- In addition to property insurance for direct damages, businesses may also have a policy for indirect loss coverage for business interruption and loss of rents or rental value. CRS says that such insurance pays the necessary expenses that continue and the net profits that would have been earned (including rental income) during a period of interruption for a covered incident. Such policies are usually written subject to a coinsurance provision that requires coverage equal to between 50 percent and 100 percent of the firm's business income for the year covered by the policy.

- Tenants renting space in a building like the WTC, who could continue operations in other locations may also purchase what is called extra expense insurance. This insurance would provide payment for expenses that are incurred to allow these tenants to resume business at an alternate site. Financial services companies, whose earnings are derived from investments, are an example of businesses that would be likely to purchase this form of insurance.

Status of Property Insurance on the WTC

- The WTC was built and is owned by the Port Authority of New York and New Jersey (PA). Earlier this year, the PA leased the buildings for 99 years to a consortium led by New York developer

Larry Silverstein and Westfield America Inc. According to media reports at that time, the WTC was valued at $1.2 billion and was generating $200 million a year in rents. The 99 year lease, a $3.2 billion transaction, was reportedly the biggest real estate deal ever.

- In a telephone conversation with officers of the PA, CRS learned that the PA holds $1.5 billion of property damage and loss of revenue insurance on all its facilities. These facilities include the Port Authority Transport Hudson (PATH train), tunnels and bridges, port areas, airports (Kennedy, LaGuardia, Newark, and Teterboro), and the WTC. The American Insurance Group (AIG) is the PA's primary insurer, and it is unclear whether acts of terrorism or war were covered by the policies.

- The PA's coverage is on a per occurrence basis. CRS points out that this is an important nuance, because there may be some debate about whether the terrorist attack constituted one or two occurrences of damage. The PA claims two occurrences, each of which would be covered for $1.5 billion. The insurer, AIG, can be expected to seek a legal interpretation that it was only one occurrence.

- The PA's insurance is also contingent insurance with respect to property damage. This means that the property damage clause only kicks in if there are gaps in the consortium's property insurance coverage, which reportedly totals more than $3 billion in property damage and loss-of- revenue insurance. The PA's loss-of-revenue insurance is not contingent.

- Even with both the PA and the consortium's commercial property insurance coverage, it is still unclear whether the WTC was fully insured. Some analysts have concluded that only about half of the estimated replacement cost of the WTC is covered, because it was considered unlikely in actuarial terms that both towers would ever collapse. That replacement cost is projected to be around $5 billion.

OBLIGATIONS AND SOLVENCY OF INSURERS

- As the ripple effects of the attacks continue to flow through the economy, airlines are only the first businesses facing the possibility of bankruptcy. Some are now concerned that insurance companies will be unable to absorb the losses generated by unprecedented policy claims. Lloyd's of London estimates that the destruction to life and property may cost the insurance industry between $20 and $40 billion. Even assuming that claims fall at the lower end of this range, it would surpass the $19 billion cost (according to Bloomberg) of our nation's worst natural disaster for the insurance industry, Hurricane Andrew.

- Standard & Poor's insurance ratings division estimates that the industry could absorb as much as $50 billion in losses before its solvency is tested. However, losses ranging between $10 and $15 billion could severely reduce its profitability in the near-term. The financial outlook of individual insurers remains uncertain. Industry-wide losses are unlikely to be distributed in proportion to each firm's ability to pay. Consequently, Fitch, a bond rating agency, expects to look at 12-17 insurers as candidates for possible downgrades. But even in the worst case scenario, its analysts believe only a few of the relatively smaller insurers will actually receive a significant downgrade.

- Insurance underwriters have already notified airlines that their war liability coverage will be cancelled at midnight on September 24th. When most policies come up for renewal at year's end, it is likely the insurance industry will contemplate additional contract exemptions for all their existing policyholders. As the industry grapples with incorporating the formerly improbable into their risk management modeling, significant premium increases can not be ruled out. Also expect currently uninsured and under insured businesses to seek new coverage, which in turn will cause insurers to seek greater protection from reinsurers to hedge against future losses. Undoubtedly, many smaller reinsurers may also reassess whether or not they can remain participants in the reinsurance industry as its exposure to risk increases.

- In light of the financial stresses that some insurers may endure over the coming months and years, it is important to understand their policy obligations. Most insurance policies held by companies affected by the attack contain exclusion clauses that, in the event of "war risks" (defined as damage to property or life due to acts of war), would release the insurer from its contractual obligation to pay the policyholder. Should one or more insurers decide to invoke an "act of war' exclusion, the question of how the courts might rule would become crucial.

- In a memo prepared for the Budget Committee, CRS suggests it would depend on each individual court's interpretation of the material terms contained in a given private contract. The court would primarily rely on the intent of the two parties who entered into the contract to interpret the meaning of the "act of war" clause. Congressional action would only have an "instructive" impact on that interpretation, not an authoritative one.

- CRS noted that the leading decision in New York case law -- *Pan American World Airways, Incorporated v. Aetna Casualty and Surety Company* -- ruled that a "hijacking was too contained to come under the war or insurrection exclusion." Obviously the airplane attacks are much larger in scope than a single hijacking. Although the *Pan Am* case is not a definitive guide as to how courts will address such petitions, it does illustrate the fact that the NY courts have tended to rule in favor of the insured, while the insurer has the burden of demonstrating that there is not another interpretation of the "war risks" clause.

- The CRS analysis does not conclude one way or the other as to what the courts are likely to decide, but suggests that it would be within the range of possibilities for a court to rule that the events of September 11, 2001 fall under the exclusion clause, thereby relieving insurers of liability. Recent statements by the administration and the passage of Joint Resolution 23 could provide an insurance company with strong evidence that could inform a judicial interpretation of an exclusion clause. If the end result in the courts favors the insurers, then certainly policyholders could be expected to seek satisfaction elsewhere.

RETURN OF "WAR BONDS"?

- Last week, two amendments (McConnell, Johnson) were included in the Senate-passed Treasury/General Government appropriations bill that would authorize issuance of a Treasury security in response to the attacks of September 11 and to support the ensuing war on terrorism.

- Senator McConnell's amendment authorizes the issuance of "War Bonds"; Senator Johnson's amendment authorizes the issuance of "Unity Bonds." Senator Gordon Smith has also introduced legislation authorizing "U.S. Defense of Freedom Bonds." All three measures give the Secretary of Treasury discretion to prescribe the specifics of the bonds (terms, maturity, interest rates, etc.).

- How about a short history lesson? In 1935, Treasury developed the first Savings Bond, which offered an opportunity to attract the funds of small savers who were still skittish about depositing their money in the banking system. At that time, Savings Bonds could only be purchased at the Office of the U.S. Treasurer or at post offices. Over the six years 1935-1941, cumulative sales totaled about $4 billion.

- In 1941, the public debt began to rapidly expand as the war effort geared up. The Roosevelt Administration expanded the small savers program by announcing a new "Defense" Savings Bond. Treasury also offered Defense Stamps in very small denominations: 10, 25 and 50 cents, $1 and $5. Savers accumulated the stamps in albums; full albums could be redeemed for Defense Savings Bonds.

- The Administration viewed Defense Bonds and Stamps as a unifying factor in a time of great public discord and uncertainty. Demand for the securities grew, so banks were added as selling agents, and payroll savings plans were created.

- Following the attack on Pearl Harbor, Defense Bonds became War Bonds. Facing a huge financing need (the 1941 deficit was 4.3% of GDP), Treasury began a massive advertising program which included thousands of volunteers across the country.

- By emphasizing borrowing, Treasury was able to spread the cost of the war between current workers and future workers, avoid the inflation that would have resulted from financing the war by printing money, and limit tax increases. The War Bond effort also helped channel the public's funds into investment expenditures. (Many folks had money, but couldn't use it for their own consumption because of rationing and other shortages.)

- From mid-1941 through 1945, $186 billion in government securities were sold. Of this amount, $54 billion was in the form of War Bonds. There were 85 million citizens who owned bonds, believing that they too had helped win the war – about 60% of the population.

- By itself, issuing War Bonds again today does not mean we have to increase the publicly-held debt (especially since we now have a surplus – 1.5% of GDP in 2001). Nor does it mean the debt will have to be paid down more slowly. The effect of War Bonds on the publicly-held debt depends on the rate of interest on the War Bonds and how the proceeds are used.

- Presumably, the interest rate on War Bonds would be less than the rate of interest on normal Savings Bonds. If at least some investors are willing to put their investment capital where the public opinions polls are, they should be willing to accept less interest earnings on these instruments than Savings Bonds. If not, Treasury probably won't issue War Bonds in the first place.

- The total debt question then becomes one of how War Bonds are used. If the extra funds raised are used to finance more spending than otherwise would have been enacted, the debt will increase (or shrink more slowly). The same is true if the proceeds are used to finance tax cuts (net of any extra revenue from increased economic growth).

- If the proceeds from War Bonds are used to pay down other debt, the government has simply altered the composition of the debt – fewer marketable Treasury securities, more non-marketable savings-type bonds – and reduced future interest payments. In a small way, Treasury would refinance its debt at slightly lower interest rates.