# The Terrorism Risk Insurance Act of 2002

## UPDATE – January 3, 2003

TRIA Bulletin 2

**Captives and Risk Retention Groups as "Eligible Insurers"**
Late on December 18, the Treasury Department issued additional interim guidance on TRIA. The most significant aspect of this guidance pertains to the extension of the ACT to certain captives. In response to a question posed, Treasury advised that "any entity that falls within the State 'licensed or admitted' category 102(6)(A)(i), and receives and reports direct earned premium in accordance with section 102(6)(B) and Treasury's interim guidance at 67 FR 76206…will be considered by Treasury as an insurer under section 102(6)(A)(i), even if the entity is also in a self-insured or captive arrangement."

It now seems clear that any captive (or risk retention group) that

- is licensed by *any* state of the United States and
- writes qualifying property or casualty coverage on a *direct* basis and
- reports direct earned premium to such state

**is subject to TRIA**. That means such entity is now "on risk" for "certified terrorism" and, in fact, has been since November 26. This guidance has come as a bit of a surprise to many interested parties who thought the issue of captive participation would be dealt with at a later date and at the discretion of Treasury.

**Next Steps for Captives and Risk Retention Groups Deemed "Eligible"**
These entities, as other insurers, must make available "certified terrorism" coverage in amounts and subject to deductibles not materially different from coverage provided for other risks of loss. Also as other insurers, for in-force programs, these entities must issue notification, prior to February 24, 2003, of both the federal share of such terrorism losses and the premium charge for the coverage. They must also quote the premium charge at each renewal during the Act's duration.

A word on computation of appropriate premium charges: unlike traditional property and casualty insurers who have large portfolios of risks over which to spread the costs of their potential retentions under the Act, captives and risk retention groups have much narrower bases. Even so, it may be advisable for these entities to develop rating structures starting with their estimated retentions for the coming year and then allocate these across the policies involved. We assume there may have to be some justifiable rationale for any premiums developed, e.g., a premium of $10,000 for $1 billion in coverage for a "trophy" schedule is unlikely to weather the scrutiny of the state in which the captive or risk retention group is licensed or charges of "foul play" by traditional insurers.

**Prospects for Broadening TRIA's Reach**
We understand Treasury has asked for assistance in formulating criteria under which other entities—off-shore direct-writing captives and unlicensed risk pools, as examples—could be brought under TRIA. These criteria deal mainly with the following:

- a recognized registration mechanism and
- a basis on which an entity can be judged to be operating "like a real insurance company."

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Our understanding is that there is a will on the part of Treasury to expand TRIA's application, so stay tuned for further guidance on these entities. Those with vested interests in these areas may want to engage their respective lobbying groups to ensure that their positions are heard and considered.

**The Pros and Cons of Including Captives and Risk Retention Groups**

The single "con" that comes to mind is the exposure these entities will bear in the event of a "certified terrorism" loss. In 2003, an entity's retention will be equivalent to 7% of its prior year's written earned premium on qualifying property and casualty lines of coverage. This rises to 10% and 15% in 2004 and 2005, respectively. Above this retention the entity retains a 10% share of its incurred losses. This could put pressure on liquidity, unless the entity is well capitalized or the premiums it charges for terrorism can substantially offset the potential liability, at least, of the retention.

Some have pointed to the "recoupment" surcharge as another downside to participation. This is the feature in the Act that allows the federal government to recover a portion of its losses through premium surcharges. But it is essential to bear in mind these are payable *by policyholders*, not by captives or risk retention groups as some mistakenly believe. As outlined in the Act, such surcharges "may not exceed, on an annual basis, the amount equal to 3 percent of the premium charged" for a commercial property or casualty policy. There is a provision that allows Treasury to impose surcharges greater than 3 percent based on a set number of factors. One has to debate, however, whether Treasury would actually impose such additional costs when faced with the inevitable nationwide economic dislocation another terrorism act would generate.

The most significant "pro" is that in most cases, captives and risk retention groups are not now supported for "certified terrorism" by traditional reinsurance. Therefore, they were either providing the coverage with no backstop or were excluding it, putting the risks back in the laps of their policyholders. For single-parent captives with a need for protection, the choice is clear: either the corporation retains 100% of the risk or, using the captive at an equitable premium, insures 90% of the risk less the captive retention.

**In-Force and Renewal Policy Headaches**

In the month since TRIA was signed, the most problematic early effect of the Act has been the coordination (or its lack) of underwriting responses on multi-participant, multi-layered placements, particularly in-force property programs. Some carriers have been quick out of the box to assign premium charges for "certified terrorism" while others still appear to be scratching their heads. We understand the deep frustration felt by policyholders who have already had to make strategic decisions on small portions of their placements while unsure of the ratings the remainder of their insurers will develop. The only point that seems to have been clarified is that "best terms" has no relevance to these premium charges.

Also a month after signing, there are insurers who are still quoting renewals with terrorism premiums "to be advised" or "included" without identification. These practices run counter to TRIA and we are pressing to have full compliance prior to inception, as required.

**State Insurance Departments v. TRIA**
Prior to the passage of the Act, five states refused to join the NAIC initiative to standardize terrorism exclusions. These states were California, Florida, Georgia, New York and Texas. On December 23rd, New York issued its first TRIA bulletin. While confirming it has approved no terrorism exclusions, it recognizes that such may have been implemented by both the excess line market and authorized insurers writing business in the "Free Trade Zone." In all other cases, they say, in-force policies are considered to be providing full terrorism coverage and no additional premium can be charged on them. At renewal, the insurers of such policies may either exclude or limit "certified terrorism" coverage, if agreed by the insured, if 1) they have offered to make same fully available per TRIA and 2) they have filed acceptable exclusionary wording with the state. In no case can fire following be excluded or sublimited, however, even for excess lines or FTZ placements.

The December 23rd issue of Business Insurance (BI)[1] noted the following state reactions to TRIA **almost a full month after its passage**:

- "…California's position is uncertain because a bulletin on the subject is now being drafted." Prior to TRIA, BI notes that California allowed roughly 400 exclusionary filings, while refusing another 200 mostly on the grounds of excessive rates, which appears to be the only available basis for rejection.
- "Currently, Florida continues to ban terrorism exclusions for admitted insurers…As a result, policyholders automatically have terrorism coverage and 'don't have a choice' under the federal law." BI further notes that Florida's Insurance Commissioner has indicated "that he will not consider any insurer filings for terrorism exclusions."

The positions of Georgia and Texas are also not clear, although both states allow freedom of form and rate for "large risks."

There continues to be uncertainty on these states' positions and whether previously applied exclusions are valid and whether policyholders can choose not to accept "certified terrorism" coverage. We strongly suggest policyholders refer these matters to their legal counsel. We do believe, however, that the only way to obtain coverage certainty at the current time is to pay the premium indicated by the insurer. If there is disagreement over the validity of an exclusion on an in-force policy, the premium payment can be made noting it is subject to resolution of this disagreement.

We will continue to prepare updates as developments occur.


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[1] "States' Laws Clash with Federal Terror Act," Meg Fletcher


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