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MEMORANDUM

TO: Clients and Friends

FROM: Morris, Manning & Martin Terrorism Insurance Group

RE: Summary of the Terrorism Risk Insurance Act of 2002

DATE: December 12, 2002

The "Terrorism Risk Insurance Act of 2002" ("TRIA") is intended to stabilize property and casualty markets that have been suffering from the unavailability and high prices of insurance. TRIA provides a Federal backstop for terrorism losses through a program whereby the Federal government assumes most of the risk of a terrorism attack while the insurance industry provides mandated coverage through a retention and co-payment. TRIA further nullifies all conflicting terrorism exclusions and requires insurers to offer terrorism coverage under similar terms as other commercial property & casualty coverages.

President Bush signed TRIA into law on November 26, 2002. The major provisions of TRIA are as follows:

What Does TRIA Do?

- TRIA establishes the Terrorism Insurance Program (the "Program") within the Department of the Treasury, through which the Federal government will share the risk of loss from future terrorist attacks with the insurance industry. Insurers are required to offer mandatory terrorism coverage; but the Program acts as reinsurance for any losses.

- TRIA is effective November 26, 2002, and the Program is effective through December 31, 2005.

- Federal reinsurance is triggered when the Secretary of the Treasury (the "Secretary"), in concurrence with the Secretary of State and the Attorney General, certifies that an event meets the definition of an "Act of Terrorism." The Secretary's decision to certify an act of terrorism is not subject to judicial review.

  - An Act of Terrorism is defined as i) a violent act that is dangerous to human life, property, or infrastructure; ii) to have resulted in damage within the United States, or damage to U.S. air carrier, U.S. flagged vessel, certain U.S. based vessels or a United States mission; and iii) to have been committed by an individual or individuals acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States government through coercion.

  - An Act of Terrorism does not include an act committed in the course of a war declared by Congress or an act resulting in losses that do not exceed $5,000,000.

Losses resulting form an act of war, however, are covered in the case of workers' compensation. The definition also does not appear to encompass purely domestic terrorism.

- TRIA voids any terrorism exclusion for a certified Act of Terrorism in any active insurance contract. All previous state approvals of policies with exclusions that would cover a Certified Act of Terrorism are null and void. Non-certified acts of terrorism (e.g., domestic terrorism) are not covered by TRIA and may continue to be excluded.

Which Insurers are Required to Participate?

- Participation in the Program is mandatory for the first two years of the program for any insurer that is writing property and casualty insurance in the United States or its territories. The definition of insurer includes surplus lines writers and authorized alien insurers. However, Federal crop, private mortgage, financial guaranty, health or life (including group), flood, and medical malpractice insurance are all excluded from TRIA's coverage. Reinsurance or retrocessional insurance is also excluded.
    - TRIA's application to captives and other self-insurance arrangements is unclear, although the Secretary has stated that he will provide interim guidance on this issue.
    - Secretary has the authority to extend TRIA to cover group life insurance if the Secretary determines that adequate and affordable terrorism reinsurance is not available for life insurers.
- The Secretary has the authority to require insurers to participate in the Program's third year also.

How Does the Program Operate?

- Once the Secretary certifies an act as terrorism, a cost sharing mechanism partitions the loss between the insurer and the Federal government.
    - Each participating insurer is required to pay losses up to a retention amount based on the insurer's direct earned premium the previous year. The Federal government then covers 90% of the losses for the insurer above its deductible, while the insurer would pay the remaining 10% of losses.
        - For the transition period from signature to December 31, 2002, the insurer has a deductible equal to 1% of the insurer's direct earned premiums; for year one, the deductible is equal to 7%, for year two, the deductible is equal to 10%, and for year three, the insurer's deductible rises to 15%.

    - Direct earned premiums are defined as the direct premiums earned and reported in the Annual Statement in column 2 of the Exhibit of Premiums and Losses (Statutory Page 14).

- Aggregate insured losses requiring an insurer deductible and co-payment are capped at $100 billion in any one year. Congress would have to authorize payments for any losses over $100 billion in any one year.

- The government will recoup a portion of the payouts it makes through the program with a surcharge on commercial property and casualty premiums. The surcharge may not exceed 3% of the premium in any given year. Insurers are required to collect and remit the surcharge to the government.

  - For purposes of the calculation of any mandatory Federal recoupment, the insurance industry is required to retain $10 billion of risk for the first year; $12.5 billion for year two; and $15 billion for year three. The Secretary must recoup the difference between the insurance marketplace retention and the aggregate amount of losses that insurers are required to pay themselves. The Secretary also has the discretion to recover other Federal payouts through the same surcharge described above.

How Do Insurers Comply with TRIA?

- Insurers are required to "make available" coverage for insured losses due to a certified Act of Terrorism. The coverage must be available on substantially the same terms, amounts, and other coverage limitations offered to the insured for other perils.

  - Treasury has released interim guidance that clarifies that the "make available" provision does not require an insurer to provide coverage for all types of risks. For example, if an insurer is not required to cover all types of risks because a State permits exclusions for certain perils (*e.g.* nuclear, biological, and chemical) or the insurer is outside of a State's direct regulatory oversight then an insurer is not now required to provide such coverage.

- If a policy currently in force has an existing terrorism exclusion that would apply to a certified Act of Terrorism, the insurer may reinstate the exclusion if the insured agrees to the exclusion in writing; or

  - If the insured failed to pay the increased premium for the terrorism coverage <u>and</u> the insurer provided notice of the increased premium and the insured's rights with respect to such coverage at least 30 days before the effective date of the exclusion reinstatement. Insurers may comply with this notice requirement by using NAIC Model Disclosure Form No. 1, available at www.naic.org.

- TRIA requires insurers to provide clear and conspicuous notice to the insured of the premium charged for insured terrorism losses now covered by the Program and the Federal share of compensation for losses under the Program.

  - For existing (in- force) policies that include terrorism coverage issued before the date of enactment (November 26, 2002), TRIA requires that disclosure to the policyholder be made not later than February 24, 2003. Insurers may comply with this notice requirement by using NAIC Model Disclosure Form No. 2, available at www.naic.org, provided that there is no change in the existing premium (although Form No. 2 does require insurers to list the portion of the premium that is directly attributable to terrorism coverage); and

  - For policies issued by February 24, 2003, TRIA requires the disclosure to the policyholder be made at the time of offer, purchase and renewal of the policy. Insurers may comply with this notice requirement by using, where appropriate, NAIC Model Disclosure Form No. 1 (new coverage option) or Form No. 2 (coverage already included), both forms are available at www.naic.org.

  - For policies issued after February 24, 2003, insurers are required to give the above notice on a separate line item in the policy at the time of offer, purchase, and renewal.

- Insurers may provide the required notice provision through an agent or broker; however, the responsibility for ensuring such notice is provided remains with the insurer.

- TRIA preempts any state law requiring prior approval of rates and forms for coverage of a certified Act of Terrorism but does not prevent states from reviewing rates and forms retrospectively. Federal preemption of prior approval authority ends December 31, 2003.

Tort Reform

- TRIA creates an exclusive federal cause of action (preempting any state actions) for any damages from an Act of Terrorism. The litigation shall take place in U.S. District Court. Punitive damages, if awarded, will not be considered "insured losses" and therefore will not be covered by the Program.

What's Next?

- On December 3, 2002, Treasury released a Request for Comments related to Treasury's Study on the Impact of Threat of Terrorism on Availability of Group Life Insurance. Interested parties should contact Treasury by January 2, 2003, with comments and information related to the impact of terrorism on group life insurers.

- Treasury will be releasing, in the near future, either interim regulations or interim guidance on how TRIA applies to captives and self-insurance arrangements.

    - Copies of the Treasury Interim Guidance and Request for Comments may be found at http://www.treas.gov/offices/domestic-finance/financial-institution/terrorism-insurance/.

- Individual States are expected to soon issue their own bulletins on the Program. The NAIC has promulgated a Model Bulletin ("Bulletin") for States to issue to licensed and authorized insurers. Some states may choose to allow insurers to use the terrorism rates and forms immediately and later file the rates and forms within 30 days of use.

    - The Bulletin contemplates a streamlined process for state rate and form approvals. Each state is expected to set a threshold for terrorism rate increases below which approval will be automatically granted. There is no guidance available about what percentage will ultimately form the upper boundary for automatic approval, and the percentage will likely vary from state-to-state.

    - The NAIC Model Bulletin is available at www.naic.org.