

MEMORANDUM

TO: Clients and Friends

FROM: Morris, Manning & Martin, LLP
Terrorism Insurance Group

DATE: October 22, 2003

SUBJECT: Terrorism Risk Insurance Act of 2002—Final Rules on Disclosure, “Make Available” and State Residual Market Mechanisms and Workers’ Compensation Funds

SUMMARY

On October 17, 2003, the U.S. Department of the Treasury published two new final rules implementing the Terrorism Risk Insurance Act of 2002 (TRIA).¹

The first final rule addresses state residual market mechanisms and workers’ compensation funds. These entities are required to participate in the Terrorism Risk Insurance Program. The final rule adopts, without change, a proposed rule issued by Treasury last April,² except that it adds a new section requiring residual market mechanisms and workers’ compensation funds to provide the disclosures required by TRIA in order to be eligible for federal compensation for losses arising from an act of terrorism. Treasury previously waived the TRIA disclosure requirements for residual market mechanisms and workers’ compensation funds that had insufficient information to furnish the disclosures. The final rule provides that the disclosures must be provided for all policies in force or issued after January 15, 2004 in order for the policy to qualify for federal reimbursement.

The second final rule addresses the standards applicable to the disclosures required by TRIA and the requirement that insurers “make available” coverage for acts of terrorism in commercial property and casualty insurance policies. This final rule adopts the provisions of an interim final rule published by Treasury last April,³ with minor modifications as discussed below.

¹ Final Rule, “Terrorism Risk Insurance Program; State Residual Market Insurance Entities,” 68 Fed. Reg. 59715 (Oct. 17, 2003); Final Rule, “Terrorism Risk Insurance Program; Disclosures and Mandatory Availability Requirements,” 68 Fed. Reg. 59720 (Oct. 17, 2003).

² Notice of Proposed Rulemaking, “Terrorism Insurance Risk Program,” 68 Fed. Reg. 19309 (April 18, 2003).

³ Interim Final Rule with Request for Comments, “Terrorism Risk Insurance Program,” 68 Fed. Reg. 19302 (April 18, 2003).

DISCUSSION

Final Rule on State Residual Market Entities and Workers' Compensation Funds

In the preamble to the final rule, Treasury reiterates previous guidance stating that it considers all state legislatively-created residual market mechanisms, including state worker's compensation funds, that facilitate the availability of primary and excess commercial property and casualty insurance to be subject to TRIA. Treasury refers to such entities collectively as residual market mechanisms. Such entities must participate in the Terrorism Risk Insurance Program, regardless of whether they receive direct earned premiums. Treasury has published a list of residual market mechanisms it has identified that must participate in the Program. The list, however, is not exclusive. All state residual market mechanisms must participate in the Program, even if not identified on the list.

Like the proposed rule, the final rule provides that state residual market mechanisms that do not share profits and losses with private insurance companies are treated as separate insurers. Residual market mechanisms that share profits and losses with private insurers, on the other hand, are treated as risk apportioning entities, and not as separate insurers. Consistent with normal business practices, these entities should continue to report to each participating insurer its share of premium income and insured losses, which is to be included in the insurer's direct earned premium and insured loss calculations. Premiums written by a servicing carrier on behalf of a residual market entity and ceded to the entity are not included in the insurer's direct earned premiums.

The final rule goes beyond the proposed rule by imposing new requirements relating to TRIA disclosures by residual market mechanisms. Previously, Treasury had waived the TRIA disclosure requirements for residual market mechanisms that had insufficient information to provide the disclosures. The final rule ends the waiver. For policies in force or issued after January 15, 2004, the TRIA disclosures must be made to the policyholder in order for the policy to be eligible for federal reimbursement. Treasury states that the disclosures may be made by the residual market mechanism, the insurers participating in the residual market or the servicing carriers, but the ultimate responsibility for ensuring that the disclosure requirement is met rests with the insurer that will be filing any claim for federal compensation.

Final Rule On Disclosure and "Make Available" Requirements

The final rule on disclosures and the "make available" requirement adopts the interim final rule issued last April with only one substantive change. TRIA provides that for policies issued on or after February 25, 2003, insurers must disclose the premium charged for terrorism coverage and the federal share of compensation for terrorism losses "on a separate

line item in the policy”. The interim final rule stated that this requirement could be met by making the required disclosures on the declarations page of the policy, elsewhere within the policy itself, or in any rider or endorsement that is made a part of the policy. The final rule amends this provision to clarify that the disclosures also may be provided in any other document that is made a part of the policy. In addition, the final rule contains a few minor clarifications and technical corrections to the interim final rule. These changes are summarized in the attached chart.

The preamble to the final rule contains a number of clarifications and statements of policy by Treasury. Treasury rejected a recommendation from the mortgage banking industry that insurers be required to provide notice to lenders, securitizers and servicers of commercial mortgages regarding whether their borrowers accepted or rejected coverage for acts of terrorism. In addition, Treasury clarified that insurers are not required to provide the TRIA disclosures if they do not expect to seek reimbursement for terrorism losses. Providing the disclosures is a condition of obtaining federal reimbursement, but not a requirement of the law.

Treasury rejected a recommendation from one commenter to allow umbrella insurers to refuse to provide “drop down” coverage for terrorism where a policyholder has intentionally declined terrorism coverage from the primary insurer, electing instead to rely on the drop down coverage. Instead, Treasury suggested that insurers offering umbrella coverage draft their policies to exclude drop down coverage for losses arising from perils for which insurance was available from the primary insurer but which was rejected by the policyholder. Treasury confirmed that structuring the umbrella policy this way would satisfy TRIA’s “make available” requirement so long as the conditions on coverage for terrorism and other perils do not differ materially. Treasury suggested the same approach for Difference-in-Coverage insurance where the policyholder intentionally rejects underlying coverage for terrorism.

For more information about the new final rules, contact any member of the Morris, Manning & Martin, LLP, Terrorism Insurance Group:

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Attachment

**COMPARISON OF FINAL RULE⁴
AND INTERIM FINAL RULE⁵ ON TRIA DISCLOSURE AND “MAKE
AVAILABLE” REQUIREMENTS**

Section (31 CFR)	Subject	Amendments to Interim Final Rule
50.10	General disclosure requirements.	No change.
50.11	Definition of disclosure.	No change.
50.12	Clear and conspicuous disclosure.	Clarification: Section 50.12(d) regarding use of intermediary to communicate disclosures is amended to replace references to “broker” and “agent” with the term “producer”. This is purely a clarification and not a substantive change. No other changes.
50.13	Offer, purchase, and renewal.	No change.
50.14	Separate line item.	Amended to clarify that that an insurer is deemed to be in compliance with the requirement to provide disclosure “on a separate line item in the policy” if the disclosure is made: <ul style="list-style-type: none"> (a) On the declarations page of the policy; (b) Elsewhere within the policy itself; or (c) <u>In any rider or endorsement, or other document that is made a part of the policy.</u> <p>Underlined language is new. No other changes.</p>
50.17	Use of model forms.	No change.
50.18	Disclosure required by reinstatement provision.	Technical correction: Section 50.18(b)(2) amended to replace the word “insured” in the first instance in which it appears with the word “insurer”. Merely corrects an error made in the interim final rule.
50.19	Disclosure by State residual market insurance entities and State workers’ compensation funds.	See final rule on residual market mechanisms.

⁴ Final Rule, “Terrorism Risk Insurance Program; Disclosures and Mandatory Availability Requirements,” 68 Fed. Reg. 59720 (Oct. 17, 2003).

⁵ Interim Final Rule with Request for Comments, “Terrorism Risk Insurance Program,” 68 Fed. Reg. 19302 (April 18, 2003).

Attachment

Section (31 CFR)	Subject	Amendments to Interim Final Rule
50.20	General mandatory availability requirements.	No change.
50.21	Make available.	Section 50.21(a) amended to clarify that an insurer must make available coverage for certified acts of terrorism at the time of initial offer of coverage as well as at the time an insurer makes an initial offer of renewal of an existing policy. This is purely a clarification and is consistent with earlier guidance from Treasury.
50.23	No material difference from other coverage.	No change.
50.24	Applicability of State law requirements.	No change.