

Clarifying TRIA

Now that the US Treasury has clarified the participation of US captives in the TRIA reinsurance programme, *Captive Review* considers the full impact of this landmark Act

More than a year has passed since the Terrorism Risk Insurance Act of 2002 (TRIA) became law, causing the US to join the list of nations with government-sponsored terrorism insurance plans. During that time, the US Department of the Treasury has issued a series of guidance documents and regulations interpreting and clarifying the new law. Nevertheless, several important issues regarding how TRIA operates, especially with respect to captive insurers and other self-insurance arrangements, are still to be resolved.

Federal contribution

TRIA established a temporary programme of reinsurance provided by the US government for commercial property and casualty losses arising from a 'certified act of terrorism'. The programme applies to acts occurring between 26 November 2002 and 31 December 2005. Events occurring after that date will not be covered unless Congress passes – and the President signs – a new law extending the programme.

In return for the promise of federal reinsurance, insurers licensed or admitted to provide primary or excess insurance in any US state, territory or possession must offer coverage for certified acts of terrorism in all commercial property and casualty policies covering domestic risks. Insurers subject to TRIA include captive insurers licensed in any US state, territory or possession, including the US Virgin Islands. Surplus lines carriers listed on the National Association of Insurance Commissioners' alien insurers listing are also subject to TRIA.

TRIA provides that insurers must offer terrorism coverage on the same terms (except price) and in the same amounts as coverage

provided for other perils under the policy. Insurers are required to 'make available' such coverage until 31 December 2004, although the Secretary of the Treasury has discretion to extend this requirement for an additional year.

The federal reinsurance provided by TRIA is subject to a deductible calculated as a percentage of the insurer's total direct earned premiums for all commercial property and casualty policies that they cover domestic risks. The deductible is 7% in 2003, 10% in 2004 and 15% in 2005. Above the deductible, the programme pays 90% of insured losses. In addition, the reinsurance is subject to a market-wide aggregate retention equal to US\$10bn in 2003, US\$12.5bn in 2004 and US\$15bn in 2005. Reinsurance payments above the retention must be recouped by the government through a surcharge on commercial property and casualty premiums. Terrorism reinsurance is not available until market-wide aggregate losses equal or exceed US\$5m. (*For a more detailed discussion of TRIA's requirements, see Chris Tait's "Insuring the Unthinkable" Captive Review, March 2003 issue.*)

Implementation by Treasury

Over the past year, the Department of the Treasury has issued a number of guidance documents and regulations interpreting and applying TRIA. These include regulations:

- Defining which insurers must participate in the federal reinsurance programme and therefore must offer terrorism coverage and collect any premium surcharges necessary for federal recoupment
- Specifying the scope of a 'certified act of terrorism' covered by the programme
- Clarifying the types of disclosure



participating insurers must make to policyholders and how these disclosures must be communicated

- Clarifying the requirement that insurers 'make available' coverage for acts of terrorism
- Specifying how participating insurers should calculate their deductible
- Proposing procedures for obtaining reimbursement from the federal government in the event that an act of terrorism occurs
- Establishing a formal process for requesting interpretations of TRIA.

One of the Treasury's first actions was to clarify that domestic captives must participate in the reinsurance program established by TRIA. Some segments of the industry, including the Vermont Captive Insurance Association (VCIA), argued US-licensed captives should have the option to participate, but should not be required to do so. If domestic captives were required to participate, it was argued, companies with little exposure to terrorism risk would insure through an offshore captive, which would not be subject to the mandatory federal

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recoupment if a terrorism loss were to occur. In a final regulation issued in July 2003 the Treasury rejected this and other arguments for allowing domestic captives to opt in or out of the programme and reiterated its position that such insurers are required to participate.

The Treasury also has clarified that to be eligible for federal reimbursement for terrorism claims, an insurer must comply with certain requirements of TRIA to provide 'clear and conspicuous' disclosure to policyholders regarding the premium charged for terrorism coverage and the federal share of compensation. In addition, the Treasury has stated that insurers must process terrorism claims in accordance with appropriate

business practices and any prescribed federal procedures.

Recently, the Treasury published a proposed regulation that would establish procedures for reporting terrorism claims to the government and obtaining federal payment in the event of an attack. The proposed procedures would require insurers seeking federal payment to make certain certifications and submit a bordereau identifying insured losses. A particularly troubling provision of the proposed regulation would require insurers to certify payment of underlying terrorism claims in full before the government will pay its 90% share of the losses. This proposal raises significant

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solvency concerns for the insurance industry, especially captive insurers. Captive industry representatives have voiced strong opposition to this requirement and are hopeful the Treasury will rethink this aspect of the proposed regulation.

Market reaction

The market's reaction to TRIA has been mixed. A survey conducted by the Council of Insurance Agents & Brokers (CIAB) in March 2003 found nearly 60% of brokers responding to the survey said fewer than 10% of their small commercial property/casualty accounts and fewer than 20% of medium-sized accounts had purchased terrorism coverage required to be offered by TRIA. Of brokers handling large accounts, 48% said fewer than 20% of their largest customers had purchased the coverage. Large national brokers have reported similar figures. Anecdotal evidence suggests little has changed in the market since the CIAB issued its report last year.

Unfinished business

The purpose of TRIA is to encourage insurers and reinsurers to create market capacity for insuring terrorism risk. The availability of the federal reinsurance at 90 cents on the dollar is a significant incentive. However, the access to these federal dollars is offset by the threshold requirements of exceeding the substantial deductible and being subjected to the post-terrorism occurrence recoupment.

The Treasury has publicly acknowledged this may provide the opportunity for mischief. In fact, the Treasury stated in the preamble to its interim regulations implementing TRIA that

In focus



Captive Review's auditing expert Debbie Lambert, principle of Johnson Lambert & Co, describes the impact of TRIA on the auditing of a captive.

"The primary impact of TRIA on an audit of a captive is one of compliance testing. For an audit of a captive, which directly issues policies, the auditor performs certain underwriting tests, which would include evaluation of documentation of compliance with TRIA's requirement that terrorism coverage be made available to policyholders. For policyholders electing the coverage audit testing would include testing of the additional premium charged for the coverage."

it would welcome comment on the 'appropriate criteria to prevent participation in the programme by newly-formed insurance companies deemed by the Treasury to be established for the purpose of evading the insurer deductible requirements of the Act and the Program'.

The Treasury has revealed at least the outline of its criteria for avoiding the possibility that a captive structure could be deemed to be 'gaming the system' and, therefore, invalid. These criteria have emerged through several public statements by Treasury officials and do not, as yet, reside in any official Treasury publication. First, the pricing of premium must be 'arms length' on the basis of industry standards. Second, there must be a *bona fide* transfer of risk to the captive, not just the appearance of such a transfer. Third, proper documentation in the form of insurance contracts, actuarial reports and so on, that meet industry standards must exist. Finally, in regard to the issue of the recoupment, the Treasury has articulated its theory that the recoupment follows the risk and, therefore, it can obtain its recoupment even if the captive does not continue in business after the event of terrorism has occurred.

TRIA's narrow coverage

The definition of an 'act of terrorism' in TRIA is narrow. The precipitating act must be committed 'on behalf of any foreign person or foreign interest', which would exclude US domestic terrorism such as the Oklahoma City bombing. Perhaps more important, TRIA continues to permit state law to allow the exclusion of nuclear, biological and chemical (NBC) coverage. It is yet unclear how a 'dirty bomb' a conventional explosive which scatters radioactive material would fall under this exclusion. Nonetheless, the uncertainty created is a major concern.

Cell captives

Substantial thought has been given by the captive community to the possibility of

Robert H Myers Jr



antitrust and trade association law.

Myers is a partner in Morris, Manning & Martin LLP's insurance group. He practices in areas of insurance regulation,

Joseph T Holahan



terrorism insurance group and a member of the firm's insurance practice group.

Holahan is counsel for Morris, Manning & Martin LLP. Based in Washington DC, he is director of Morris, Manning & Martin's

utilising a protected cell captive for TRIA purposes. In theory, this makes a great deal of sense. The benefit of a protected cell captive is that the cell participant or 'owner' can take advantage of the reduced capital and surplus requirements of being a single cell as well as the economies of utilising single management for multiple cells and a single investment manager.

However, the problem is that the definition of 'insurer' in TRIA requires that the 'insurer' must be 'licensed or admitted to engage in the business of providing primary or excess insurance in any state'. While a US domiciled cell captive has a license, the individual cell does not. This creates the problem that the Treasury is likely to view all of the cells in an aggregate form. For example, the premium of all the cells will be aggregated for the purposes of determining the insurer deductible as well as for purposes of determining the recoupment assessment. This defeats the purpose of utilising a cell captive structure and needs to be remedied by the Treasury.

JUAs and pools

Joint underwriting associations and pools provide an enormous amount of direct coverage to states, cities, and municipalities. Their status under TRIA is ambiguous. Many of these pools do not readily fit into the 'state-licensed or admitted' category because they may be licensed by an entity other than the insurance department of a state and may be subjected to different kinds of regulation under state law.

The Treasury's regulations address this issue, but do not come close to the specificity that will be necessary for risk managers and their counsel to rely upon. As a result, the managers of these pools are unclear as to whether they are mandated to offer terrorism cover and whether, if they offer it, the federal reinsurance is available.

Quo vadis TRIA?

Uncertainty as to the future of TRIA is a significant problem and has a chilling effect on the utilisation of the programme. Congress decided the TRIA legislation should sunset on 31 December 2005. This means the programme will go into a run-off mode (if an act of terrorism has occurred) commencing on that date. In addition, the 'make available' requirement for policies covering any portion of 2005 is subject to a decision by the Treasury no later than 1 September 2004. In other words, if the Treasury does not decide to require the 'make available' requirement for 2005, then TRIA coverage will end (unless voluntarily extended) on 31 December 2004.

Conclusion

TRIA was intended to compensate for what was hoped to be a short-term problem with capacity in the US market for terrorism insurance and reinsurance following the events of 11 September. Yet continued uncertainty about the future of the reinsurance programme established by TRIA and uncertainty about other aspects of the law has operated as an impediment to the full utilisation of TRIA for its intended purpose: creating a viable insurance and reinsurance market for terrorism cover.



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