Overview of the U.S. Terrorism Risk Insurance Act of 2002

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I Introduction

Following the substantial losses experienced by the industry on September 11, 2001, there was significant uncertainty in the markets for commercial lines property and casualty insurance coverage. Soon after the tragic events, many reinsurers announced that they did not intend to provide coverage for acts of terrorism in future reinsurance contracts. This led to an effort on behalf of numerous interested parties to seek a temporary federal backstop to calm market fears over future terrorist related losses and the ability for the insurance industry to allocate capital to provide coverage for such catastrophic events.

Following a year of debate in Congress and the introduction of various bills, on November 26, 2002, the President signed into law the Terrorism Risk Insurance Act of 2002 ('Act'). The Act became effective immediately. It establishes a temporary Federal program ('Program') of shared public and private compensation for insured commercial property and casualty losses resulting from an act of terrorism, as defined by the Act. The Program will be administered by the Secretary of the Treasury ('Secretary'). The Department of the Treasury ("Treasury") issued certain final rules regarding the interpretation and application of the Act on July 8 and August 8, 2003.

Under the Act, the Federal government pays 90% of insured losses in excess of an insurer's deductible, while the insurer pays 10%. An insurer's deductible is based on a percentage of direct earned premiums for the previous calendar year. Insurers' deductibles are 7% in 2003, 10% in 2004, and 15% in 2005. Insurers may reinsure their insurer deductibles and 10% co-shares. Losses covered by the Program are capped at $100 billion per year. Above this amount, Congress is to determine the procedures for and the source of any payments.

Below are highlights of the major aspects of the Act as well as certain regulatory interpretations of the Act since its inception.

II Mandatory Participation

Under the Act, all 'insurers' receiving 'direct earned premiums' for any type of commercial 'property and casualty insurance' coverage must participate in the Program.

A Must be an Insurer

'Insurer' under Section 102(6) of the Act means any entity and "affiliate" thereof –

(A) that is –

1 licensed or admitted to engage in the business of providing primary or excess insurance in any State;

2 an eligible surplus lines carrier listed on the Quarterly Listing of Alien Insurers of the National Association of Insurance Commissioners ('NAIC'), or any successor thereto;

3 approved for the purpose of offering property and casualty insurance by a Federal agency in connection with maritime, energy, or aviation activity;

4 (iv) a State residual market insurance entity or State workers' compensation fund;

(B) that receives direct earned premium for any type of commercial property and casualty insurance coverage.

Affiliated insurers are treated collectively as one entity by Treasury for purposes of calculating direct earned premiums and an insurer deductible under the Program. Non-entity insurers, however, are not included in the definition of "affiliate" because these entities do not have "direct earned premiums" as defined in the Act.

The definitions of "affiliate" and "control" are intertwined in the Act. Section 102(2) defines "affiliate" to mean "with respect to any insurer, an entity that controls, is controlled by, or is under common control with the insurer." The statutory definition of "control" in Section 102(3) contains three categories. Section 102(3)(A) and (B) establish conclusive control under certain circumstances for purposes of the Program. Section 102(3)(C) addresses those situations where a relationship between or among insurers does not fit within the conclusive control provisions. In such cases, control may still exist for purposes of the Program if Treasury determines that an entity directly or indirectly exercises a controlling influence over the management or policies of another entity.

The following definitions of "control" are clarified and interpreted by Treasury in the July 8 final rule as follows:

(a) Under Section 102 (3)(A) of the Act, "an entity has control over another entity if the entity directly or indirectly or acting through 1 or more persons owns, controls or has the power to vote 25 percent or more of any class of voting securities of the other entity." Treasury interprets the 25 percent voting securities threshold as an objective standard that establishes conclusive control for purposes of the Act, which is not subject to rebuttal.

(b) Under Section 102(3)(B) of the Act, if an insurer controls in any manner the election of a majority of the directors or trustees of another insurer, then the insurer controls another insurer for purposes of the Program. Treasury interprets this section as another objective standard that establishes conclusive control for purposes of the Act, which is not subject to rebuttal.

(c) If an insurer does not come within the conclusive control provisions of Section 102(3)(A) or (B), but at least two of the following control factors exists, then, under the July 8 rule, Treasury will presume controlling influence exists prior to a final determination unless and until rebutted by the insurer:

- the insurer is one of the two largest shareholders of any class of voting stock;
- the insurer holds more than 35 percent of the combined debt securities and equity of the other insurer;
- the insurer is party to an agreement pursuant to which the insurer possesses a material economic stake in another insurer resulting from a profit-sharing arrangement, use of common names, facilities or personnel, or the provision of essential services to another insurer;
- the insurer is party to an agreement that enables the insurer to influence a material aspect of the management or policies of another insurer;
- the insurer would have the ability, other than through the holding of revocable proxies, to direct the votes of more than 25 percent of the other insurer's voting stock in the future upon the occurrence of an event;
- the insurer has the power to direct the disposition of more than 25 percent of a class of voting stock in a manner other than a widely dispersed or public offering;
- the insurer and/or the insurer's representative or nominee constitute more than one member of the other insurer's board of directors;
- the insurer or its nominee or an officer of the insurer serves as the chairman of the board, chairman of the executive committee, chief executive officer, chief operating officer, chief financial officer or in any position with similar policymaking authority in another insurer;

(d) If a State has determined that an insurer controls another insurer, *and* at least *one* of the factors listed above exists, then Treasury will presume a controlling influence exists unless and until rebutted by the insurer.

(e) If an insurer provides 25 percent or more of another insurer's capital in the case of a stock insurer, policyholder surplus (in the case of a mutual insurer) or corporate capital (in the case of other entities that qualify as insurers), and at least one of the factors listed above exists, then Treasury will presume a controlling influence exists unless and until rebutted by the insurer.

(f) If an insurer, at anytime during the Program Year, supplies 25 percent or more of the underwriting capacity for that year to an insurer that is a syndicate consisting of a group including incorporated and individual unincorporated underwriters, and at least one of the factors listed above exists, then Treasury will presume a controlling influence unless and until rebutted by the insurer.

(g) To address those situations set forth above in paragraphs (c)-(f), Section 102(3)(C) of the Act authorizes Treasury to make a determination whether an insurer directly or indirectly exercises a controlling influence over the management or policies of another insurer, after notice and opportunity for hearing. Although the July 8 final rule sets no deadline for an insurer to request a hearing, Treasury encourages insurers that do not come within the conclusive control provisions but that are in a relationship or arrangement in which the control factors apply or exist to request a hearing as soon as possible if they wish to rebut the regulatory presumptions of controlling influence and obtain a final determination from Treasury of whether the relationship involves a controlling influence (and therefore control).

Treasury has decided to interpret the Act as generally excluding non-insurers from the definitions of affiliate and control at this time. Treasury, however, notes in the July 8 final rule that it could revisit this issue if it finds evidence that other corporate structures or arrangements are being used or thwart the goals and purposes of the Program

B Must Receive Direct Earned Premiums

The term 'direct earned premium' means a direct earned premium for property and casualty insurance issued by any insurer for insurance against losses occurring:

1 within the United States; or

2 to an air carrier, to a United States flag vessel, or at the premises of any United States mission.

Under Section 102(6) of the Act, an "insurer" calculates its "insurer deductible" based on the insurer's "direct earned premium." In the August 8, 2003 final rule, Treasury revised the regulatory definition of "direct earned premium" to ensure that it parallels with the definition of direct earned premium for State licensed or admitted insurers that report to the NAIC and certain eligible surplus line carrier insurers. "Direct earned premium" is not to be read narrowly to refer only to direct earned premiums for losses resulting from acts of terrorism. Rather, "direct earned premium," as provided in Section 102(4) of the Act, consists of direct earned premium for all commercial property and casualty insurance (as the term is used in the Act and Treasury's regulations) issued by an insurer for insurance against losses at the above specified locations.

C For Property and Casualty Insurance

"Property and casualty insurance" policies are defined in Section 102(12) of the Act to mean 'commercial lines of property and casualty insurance, including excess insurance, workers' compensation insurance and surety insurance' but does not include:

Crop or livestock insurance, including Federal crop insurance;

private mortgage insurance;

financial guaranty insurance issued by monoline financial guaranty insurance corporations;

medical malpractice insurance;

health or life insurance, including group life insurance;

flood insurance provided under the Federal flood program;

title insurance; or

reinsurance or retrocessional reinsurance.

Treasury consulted with the NAIC and others concerning the definition of commercial property and casualty insurance. Finding no uniform or consistent definition of the term, Treasury determined that the National Association of Insurance Commissioners ("NAIC") Statutory Page 14 provided the best available point of reference – not only for identifying the likes of coverage for the Program, but also for guidance in determining an insurer's direct earned premium for those lines of coverage. Treasury intended that the list of specified lines on Statutory Page 14 would be exclusive, and premiums reported on other lines would not be part of the Program. The July 8 final rule revises the previous language to clarify this.

III Mandatory Availability

An insurer must 'make available', in all of its property and casualty insurance policies, coverage for 'insured losses'. Previous terrorism exclusions are void as of November 26, 2002 to the extent that they are inconsistent with the Act.

A Make Available

An insurer is required to offer coverage to a policyholder for acts of terrorism that does not differ materially from the terms, amounts, and other coverage limitations offered to the policyholder for losses from events other than acts of terrorism. The insurer must provide clear and conspicuous disclosure to the policyholder of the premium charged for insured losses covered by the Program and the Federal share of compensation for insured losses under the Program. The NAIC issued model disclosure forms that reflect what key information must be disclosed. This notice must be delivered:

1 within 90 days after enactment of the Act for existing

2 upon offer, purchase and renewal of policies issued within 90 days after enactment; and

3 as a separate line item in the policy at the time of offer, purchase and renewal for policies issued more than 90 days after enactment.

B Insured Loss

The term "insured loss" means any loss resulting from an act of terrorism (including an act of war, in the case of workers' compensation) that is covered by primary or excess property and casualty insurance issued by an insurer. Section 102(1) of the Act defines "an act of terrorism" as any act certified by the Secretary of the Treasury, in concurrence with the Secretary of State and the Attorney General:

1 to be an act of terrorism;

2 to be a violent act or an act that is dangerous to:

   (a) human life;

   (b) property; or

   (c) infrastructure;

3 to have resulted in damage within the United States; or – regardless of where the loss occurs – to an air carrier, a vessel bearing the United States flag or certain

other vessels whose insurance coverage is subject to regulation in the United States; or at the premises of a United States mission; and

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 by coercion.

An act does not qualify as an act of terrorism if:

1 committed as part of the course of a war declared by Congress (except in the case of workers' compensation coverage), or

2 property and casualty insurance losses resulting from the act, in the aggregate, do not exceed $5,000,000.

In the July 8 final rule, Treasury confirmed the meaning of insured loss as it relates to section 102(5)(B) of that Act as follows:

(a) A loss that occurs to an air carrier (as defined in 49 U.S.C. 40102), to a United States flag vessel, or a vessel based principally in the United States, on which United States income tax is paid and whose insurance coverage is subject to regulation in the United States, is not an insured loss under section 102(5)(B) of the Act unless it is incurred by the air carrier or vessel outside the United States.

(b) An insured loss to an air carrier or vessel outside the United States under section 102(5)(B) of the Act does not include losses covered by third party insurance contracts that are separate from the insurance coverage provided to the air carrier or vessel.

Therefore, for purposes of the Program, an insured loss is "any" loss, including a third party liability loss, if it occurs within the geographic boundaries of the United States; but, if the loss occurs outside of the geographic boundaries of the United States (extraterritorial) to a United States air carrier or vessel, then only that portion of the loss "to" that air carrier or vessel is an insured loss eligible for the backstop. To further clarify, "to" in this context means insured losses that are incurred by United States air carriers and vessels (e.g., through United States air carriers' or vessels' property and liability insurance coverage), not losses that are incurred by other entities that are covered by third party insurance contracts that are separate from the insurance coverage provided to the air carrier or vessel.

C Terrorism Exclusions are Void

The Act voids any terrorism exclusion in a contract for property and casualty insurance that is in force on the date of enactment of the Act to the extent that it excludes losses that would otherwise be insured losses.

The Act also voids any state approval of any terrorism exclusion from a contract for property or casualty insurance that is in force on the date of enactment of the Act to the extent that it excludes losses that would otherwise be insured losses. The Act allows insurers to reinstate a preexisting provision in a contract for commercial property and casualty insurance that is in force on the date of the enactment of the Act and exclude coverage for acts of terrorism only if one of two conditions are met:

1 The insurer must have received a written statement from the insured that affirmatively authorizes such reinstatement; or

2 if the insurer has provided notice to the insured, at least 30 days before any such reinstatement and the insured fails to pay any increased premium charged by the insurer for providing such terrorism coverage.

IV. Conditions for Payments under the Program

An insurer's ability to collect under the Act is conditional on, among other things, correctly 'making available' coverage for terrorism losses. In order for an insurer to receive payments for insured losses by the Program, the following conditions must be met:

1 An insured that suffers an insured loss must file a claim with the insurer;

2 the insurer must have provided the required disclosure to the policyholder regarding coverage terms and availability;

3 the insurer must process the claim in accordance with its standard business practices and any procedures established by the Secretary; and

4 after meeting the applicable deductible, the insurer must submit a claim for payment for the Federal share of compensation under the Program, including written certification of the underlying claim and all payments made for insured losses as well as certification of the insurer's compliance with the requirements of the Program.

IV Other Act Provisions

A Mandatory Recoupment

If compensation for insured losses is paid under the Program, the Secretary is required to collect terrorism loss risk-spreading premiums. Collection for terrorism loss risk-spreading premiums will be done through a surcharge of up to 3% of the annual premium on commercial property and casualty insurance policies in effect after the date the Secretary establishes such premiums.

B Exclusive Federal Cause of Action

The Act provides for a Federal cause of action for property damage, personal injury or death arising out of or resulting from an act of terrorism. Such claims are to be consolidated into a single Federal district court. Punitive damages awarded in such actions are not counted as insured losses under the Program.

V Guidance on Application of the Act

Below are some of the significant developments regarding the interpretation and application of the Act since its inception:

November 26

The NAIC membership adopted a model bulletin to assist insurers in complying with the Act. It describes steps that insurers must take to conform to relevant portions of the Act. The basic bulletin recognizes that 46 jurisdictions have allowed some coverage limitations related to acts of terrorism that are affected by the Act. Five jurisdictions have not generally allowed coverage limitations related to acts of terrorism.

The NAIC membership adopted two model disclosure forms to assist insurers in complying with the Act. The model disclosure forms may be used by insurers to meet their obligation under the Act to inform policyholders of the status of current coverage, and in some cases, make a selection regarding full insurance coverage for acts of terrorism. These forms must be used in light of the current policy language, state legal requirements and the provisions of the Act.

December 3

A notice was issued by the U.S. Department of the Treasury that provides the first interim guidance to insurers concerning:

1 certain statutory disclosure and mandatory availability requirements contained in the Act;

2 the types of commercial property and casualty insurance covered by the Act; and

3 the term 'direct earned premium' as used in the Act.

December 18

A notice was issued by the U.S. Department of Treasury that provides the second interim guidance concerning:

1 what entities are 'insurers' as defined in Title I of the Act and are, therefore, required to be participants in the Program;

2 the scope of insurance coverage under the Program, including guidance to assist participating insurers in estimating their 'insurer deductible' prior to the issuance of regulations, based on how they report their 'direct earned premium' (or comparable format); and

3 additional guidance concerning required disclosures under the Act.

January 22

A notice was issued by the U.S. Department of Treasury that provides the third interim guidance concerning:

1 how an insurer may comply with Section 103(b)(2) requirements for disclosure at the time of offer, purchase and renewal of the policy;

2 how an insurer may comply with the 'separate line item' requirement for policies issued more than 90 days after the date the Act was effective;

3 how an insurer may certify its compliance with the required disclosures as a condition for payment under Section 103(b) of the Act;

4 how the nullification requirement of Section 105 and other provisions of the Act apply to non-US insurers; and

5 for the purpose of determining the scope of 'insured loss,' how Section 102(5)(B) is interpreted as it relates to U.S. Air carriers and U.S. Flag vessels.

February 25

A notice was issued by the U.S. Department of Treasury that provides an interim final rule concerning:

1 what is an "act of terrorism" under the Program;

2 what entities must participate in the Program (clarifying the terms "affiliate", "control", "insurer");

3 what is the scope of insurance coverage under the Program. ("Insured loss", "property and casualty insurance", and "direct earned premium").

The interim final rule establishes a new Part 50 in Title 31 of the Code of Federal Regulations, 31 CFR Part 50.

March 25

A notice was issued by the U.S. Department of Treasury that provides the fourth interim guidance which provides insurers with a procedure by which they could seek to rebut a presumption of control established in Treasury's first set of interim final regulations.

April 15

A notice was issued by the U.S. Department of Treasury that provides interim final rules concerning:

1 the disclosure requirements;

2 mandatory availability.

A notice also was issued by the U.S. Department of Treasury that provides the proposed rulemaking concerning:

3 mandatory participation as an "insurer";

4 treatment or allocation of premium;

5 other state residual market insurer issues;

6 disclosures.

May 19

A letter response was published by the U.S. Department of Treasury concerning whether the "declared war" exclusion would apply to acts committed in connection with the hostilities in Iraq.

The Department of Treasury gave its interpretation of the statue that a terrorist act committed in the United States in connection with then recent hostilities in Iraq would not be excluded from coverage under TRIA solely by operation of the "declared war" exclusion. Under the Act, a war must be declared by Congress to be excluded.

July 8

A notice was issued by the U.S. Department of Treasury that provides final rules, which adopted interim final rule issued on February 25, 2003, with a few revisions based upon the comments received.

August 8
A notice was issued by the Department of Treasury that provides clarification of the July 8 rule definition of "direct earned premium."

State Regulatory Action
On December 23, 2002, the New York Insurance Department ('NYID') issued Circular Letter No. 25 (2002) to provide guidelines to insurers with respect to the issuance in New York of policies subject to the Act and to supplement the Interim Guidances Issued by the Department of the Treasury on December 3 and 18. Reference is also made to the Model Bulletin on terrorism issued by the NAIC on November 26. The Circular Letter also provides guidance to property/casualty insurers with respect to the underwriting criteria and policy terms and conditions applicable to limitations of coverage in property/casualty policies for terrorist acts that are not covered by the Act.

Since November 26, 2002, other states have issued guidelines to insurers with respect to the issuance of policies subject to the Act and reinstatement and filing of exclusions. Those states include Alaska, Alabama, Arkansas, Connecticut, Florida, Indiana, Iowa, Kentucky, Maine, Massachusetts, New Hampshire, New Jersey, North Carolina, North Dakota, Oklahoma and South Dakota. Many of these states reference state law requirements for fire coverage, asserting that an insured cannot waive this statutorily mandated coverage. New York specifically requires that any policy that contains an exclusion or limitation for loss or damage caused by an act of terrorism must clearly indicate that it does not apply to loss or damage caused by or resulting from fire that ensues from terrorism.

VI U.S. Market Impact
Since September 11, the movement of business from the U.S. admitted market to the U.S. surplus lines market has continued to increase significantly. Many insurers have restricted how much exposure they are willing to take on an admitted basis and, as a result, business has been moved over to the surplus lines carriers, many times to another insurer within the same insurance group. New and renewal underwriting guidelines by admitted carriers have become extremely strict in order to eliminate any concentrations in exposure.

Insurers still have to check with each state's law to see how broadly any terrorism exclusion will be interpreted. As mentioned above, in New York, for example, it is the continued position of the NYID that fire following a terrorism loss cannot be excluded since fire cover is mandated by statute. Numerous states seem to be willing to view their own fire statute with similar interpretation.

Finally, once the Program expires, insurers may be faced with tail exposure. Many carriers may use policy terms, forms and/or policy language that may not coincide with the expiration of the Program. Insurers need to examine, on a state by state basis, what options might be available to eliminate the risk on December 31 in the event the Program is not continued beyond December 31, 2004 or 2005. Unless careful planning is done in advance, insurers may find themselves with significant terrorism exposure in the U.S. with the Program in place for protection.

This article was submitted for publication on 15 August 2003. Thus, any subsequent rules or guidance issued by the Treasury after the above date is not summarised in this article.

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