

# TRIA AND CAPTIVE INSURANCE PROGRAMS

**WHEN EXTENSION OF THE TERRORISM RISK INSURANCE ACT OF 2002 (TRIA) CAME DOWN TO THE WIRE AT THE END OF LAST YEAR, COMPANIES WITH TERRORISM EXPOSURES WERE PREPARING TO SCRAMBLE FOR COVERAGE. THE TRIA EXTENSION PASSED WITH DAYS TO SPARE, BUT THE NEED AND OPPORTUNITY TO CONSIDER COVERAGE OPTIONS HAS NOT GONE AWAY. ONE INCREASINGLY POPULAR OPTION IS AN INSURANCE CAPTIVE.**

Captive insurance programs provide a form of self insurance, offering companies an alternative method of funding for risk. One of the most obvious benefits is accumulation of investment income. A captive, which is a subsidiary of the company that creates it, can retain the premium and pay its parent dividends, net of reinsurance, if there are no losses during the policy period. Other immediate benefits of a captive insurance company can include:

- Tailored, expanded coverage
- Pricing stability in an unstable marketplace
- Direct access to reinsurance
- Greater claims control
- Access to increased insurance capacity

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Companies that have been penalized by exorbitant rates for terrorism insurance because they are located in high-risk areas are frequently finding the creation of a captive insurance vehicle as a simple, cost-effective route to securing adequate insurance.

## TRIA COVERS CAPTIVES

TRIA and its subsequent extensions serve as reinsurance for commercial Property and Casualty policies covering losses due to acts of terrorism in the U.S.<sup>1</sup> In exchange for federal support, insurers are required to offer terrorism coverage. Captives are expressly included – captives domiciled in the U.S. providing Property and Casualty coverage on a direct basis are eligible for TRIA support. They are obligated to offer terrorism coverage and comply with the act's reporting provisions. Currently, domestic captives are direct writing certified terrorism coverage most commonly for Property exposures.

According to the recent seven-year program extension (the Terrorism Risk Insurance Program Reauthorization Act or TRIPRA) TRIA support is available for losses resulting from acts certified by the Secretary of Treasury as eligible for the TRIA backstop. The criteria for certification are:

- A violent act or an act dangerous to human life, property or infrastructure
- Damage within the U.S. or to a U.S. aircraft or water vessel, or to a U.S. mission abroad
- Losses exceeding \$5 million in the aggregate.

Once an act is certified, insurers providing TRIA coverage would be subject to a deductible equivalent to a percentage of their annual direct earned premiums (20% in 2007) and would subsequently be eligible for an 85% quota share reinsurance reimbursement from the federal government for certified terrorism losses in excess of the deductible.

A captive providing terrorism coverage under TRIA offers several advantages over a commercial insurance carrier, in addition to the typical advantages of a captive program.

- Because the typical aggregate earned premium for a captive insurer is minimal compared to that of commercial insurers, the deductible amount is often quite low.
- Department of the Treasury guidelines indicate that TRIA will respond to certified losses resulting from nuclear, biological and chemical perils – typically excluded in commercial terrorism policies.
- Captives are not required to pay funds to their policyholders in advance of receiving reimbursement from the federal government, alleviating cash flow issues.

On the whole, corporations accessing TRIA directly through their captive subsidiaries generally have broader coverage, and, in the event of no loss, may recoup premiums.

TRIA coverage has its limitations. In addition to the 15% quota share, the TRIA program includes a coverage trigger that requires aggregate insured losses to exceed \$100 million before government participation is available. Captives will be under pressure to consider commercial reinsurance to cover these retained losses.

<sup>1</sup> Information on TRIA and subsequent extensions thereto may change depending on the terms and conditions of the regulations to be established by the Secretary of Treasury.

## PROS AND CONS OF A TRIA CAPTIVE

### PROS

- Provides direct TRIA coverage for the entire program, less self-insured retentions, which may be difficult or expensive to secure in the insurance marketplace
- Stabilizes coverage and rates for the foreseeable future
- Can write perils unavailable in commercial market that are backstopped by TRIA (including nuclear, biological, chemical and radiological terrorism)
- Can include multiple lines (Property, Liability, OCIPs, Builders Risk, etc.)
- Wording can be extended beyond the scope of TRIA and the risk funded separately

### CONS

- The company retains a 15% quota share of the dollar captive limit unless reinsured
- The company retains the \$100 million exposure below the TRIA trigger unless reinsured
- Does not eliminate the costs of terrorism insurance for international exposures or risks falling outside of TRIA terrorism definition

# HYPOTHETICAL TRIA CAPTIVE SCENARIO

## Premium and Loss Scenario (in Millions)

**Captive Limits: 1,000**

Premium Rate 0.0020  
 Annual Gross Direct Premium 2  
 Certified Terrorism Loss 250

**STEP 1**

### TRIA Deductible Calculation

Captive's TRIA Deductible 0.4 (20% of Annual Premium)  
 Excess Loss 249.6

**STEP 2**

### TRIA Reimbursement

TRIA 85% Q/S 212.2  
 Captive 15% Q/S 37.4

**STEP 3**

### Captive Reinsurance Program

Losses subject to Reinsurance 37.4 (does not include TRIA Deductible)  
 100% reinsurance 37.4

**Retained Loss 0.4**

## Capital and Expense Calculation

Minimum statutory capital 250,000 (Cash / Cash Equivalent)  
 Minimum additional surplus based on premiums (if any) *tbd*

**Required Surplus and Capitalization 250,000**

Feasibility study 30,000  
 Actuarial analysis 10,000  
 Domicile implementation 5,000  
 Misc. fees (legal, tax, etc.) 25,000

**Total Captive Creation Costs 70,000**

Captive Management 50,000  
 Annual Audit 25,000  
 Misc. fees (actuarial, taxes, etc.) 18,000 *tbd*

**Ongoing Annual Captive Operating Costs 93,000**

## MOVING AHEAD

Forming a captive takes several steps once a feasibility study points the way forward. One of the first steps is choosing a domicile. Several states are available as domiciles for terrorism captives, including Vermont, South Carolina, New York and Washington DC. Only domestic captives qualify for TRIA support. A detailed matrix comparing some U.S. domiciles appears below. Each domicile has its own process for setting up a captive. As an example, we outline the steps to licensing a captive in New York.

- Arrange a preliminary meeting with the New York Insurance Department (NYID) Captive Group to discuss the proposed captive and to review the licensing and incorporation process
- Obtain approval for the name of the captive
- Prepare and submit four completed captive insurance company license application forms with all required attachments, to the NYID Captive Group including:
  - A copy of the charter and bylaws or other similar documents
  - A financial statement certified by two officers
  - A plan of operation

The submitted application should also include:

- Biographical affidavits for directors and executive officers of the proposed captive insurer
- Pro forma financials for the next five years
- Actuarial analysis
- Loan agreement
- An independent valuation (if required)

The content for the plan of operation is set forth in the application form. It must include an actuarial report or feasibility study prepared by a qualified independent actuary. Any proposed changes to the plan of operation subsequent to licensing must be submitted to the New York superintendent of insurance 30 days before becoming effective.

Letters of credit can be used to meet capital and surplus requirements.

## INCORPORATION

After review of the proposed charter and by-laws by the NYID, the applicant submits an executed copy of the charter. For stock insurers, an incorporation tax of one-twentieth of one percent of the par value of capital stock must be submitted to the NYID (New York Tax Law Section 180) at this time. The executed copy of the charter is forwarded by NYID to the New York State attorney general for recording and the NYID issues a certificate of incorporation to the captive company.

After incorporation, the applicant must submit a certified, notarized copy of the by-laws and proof of funding. In addition, the captive insurance company must designate power of attorney to the superintendent as agent for service of process. This submission is accompanied by a certificate of designation naming the person to whom the superintendent can forward any process served upon him. A certified copy of these resolutions by the board of directors authorizing both the appointment and the designation is also required.

# CAPTIVE DOMICILE COMPARISON

	Vermont	New York	Washington DC	South Carolina
<b>Minimum equity value of parent/affiliates</b>				
	N/A	\$100M	N/A	N/A
<b>Minimum captive capitalization</b>				
	Pure - \$250,000	Pure - \$250,000	Pure - \$250,000	Pure - \$250,000
	Sponsored (protected cell) - \$500,000	Protected cell structures disallowed	Rental (protected cell) - \$400,000	Sponsored (protected cell) - \$1,000,000
<b>Implementation/Feasibility Fees</b>				
	\$30,000	\$30,000	\$30,000	\$30,000
<b>Surplus options</b>				
Cash	Yes	Yes	Yes	Yes
LOC	Yes	Yes	Yes	Yes
Receivables	Possible	Possible	No	No
Intangibles	Possible	Possible	No	No
Other assets	Possible	Possible	No	Sponsored captive not assuming risk upon approval
<b>Premium to surplus ratio</b>				
	None Specified	None Specified	None Specified	Free surplus must be the greater of \$300 million or 10% of reserves.
<b>Provision for loan-backs to parent/affiliates</b>				
	Yes, prior approval, demand note basis	Yes, prior approval, demand note basis	Upon Approval	Limited to pure captives at the discretion of the regulatory body
<b>Taxes &amp; Assessments - Direct Written Premium</b>				
\$0-\$20M Premium	0.38%	0.40%	Minimum for all others - \$7,500 First \$25M - 0.250%	0.40%
\$20M-\$40M Premium	0.29%	0.30%	\$25M to \$50M - 0.150%	\$20MM and over - 0.30%
\$40M-\$60M Premium	0.19%	0.20%	Over \$50M - 0.050%	-
\$60M+ Premium	0.07%	0.08%	-	-
Premium Tax Cap	\$200,000	minimum \$5,000	\$100,000 for all companies	\$100,000
Assessments/License Fees	\$300 License Renewal	0.25% of gross premium written on NY-based risk	Application review fee - \$500  Certificate of authority - \$300 License renewal - \$300	\$5,000 annual tax payable by captive reinsurance company only Annual renewal - \$500 Application fee - \$200 Initial license fee - \$300
<b>Taxes &amp; Assessments - Assumed Written Premium</b>				
\$0-\$20M Premium	0.214%	0.225%		0.225%
\$20M-\$40M Premium	0.143%	0.15%	First \$25M - 0.2250%	0.15%
\$40M-\$60M Premium	0.048%	0.05%	\$25M to \$50M - 0.150%	0.05%
\$60M+ Premium	0.024%	0.025%	Over \$50M - 0.025%	0.025%
Premium Tax Cap	\$200,000 max, \$7,500 \$7,500 min	minimum \$5,000	\$100,000 for all companies	\$100,000

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