

**UPDATE - February 12, 2003**

## Are Captives Viable Alternatives to the Traditional Marketplace for TRIA Coverage? *A Measured Response*

When the Treasury Department issued its second interim guidance on December 18, its pronouncement with regard to eligibility of captives took many in that segment of the insurance industry by surprise. Treasury advised that if an insurer "is licensed or admitted in any State as defined in the Act and...provides direct property and casualty insurance coverage as defined in the Act...and...reports its direct earned premiums...to any State" such insurer is deemed eligible.

Captive sponsors, managers and regulators were forced to respond quickly to the immediate financial implications of this pronouncement: since November 26, when TRIA was passed, eligible captives have been "on risk" for certified terrorism, without benefit of either premium income or, in most cases, reinsurance for the risks they retain.

As with any other line of insurance offered by a captive, certified terrorism is subject to regulation by authorities in its domicile. Therefore, business plans covering the following must be developed, presented and accepted by the authorities:

- *Amount of Cover*

While TRIA requires that a carrier offer certified terrorism in amounts equivalent to other lines of coverage, it does not appear to preclude the captive and its insured from agreeing to more or less coverage once the initial offer of insurance has been made.

- *Fire Following Terrorism*

An eligible captive insurer has no more latitude in providing fire following terrorism than its commercial peers. Therefore, should its insured either decline certified terrorism coverage or accept a sublimit on such coverage, **neither step reduces the captive's liability for resulting fire in the various states and territories with laws mandating this coverage.** As a reminder, these include:

Arizona, California, Connecticut, Georgia, Hawaii, Idaho, Illinois, Iowa, Louisiana, Massachusetts, Maine, Michigan, Minnesota, Missouri, Nebraska, New Hampshire, New Jersey, New York, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, Virginia, Washington, West Virginia, Wisconsin and the US Virgin Islands.

The issue of liability for fire resulting from a terrorism event, even in the face of exclusions of terrorism, has haunted the traditional insurance marketplace since 9/11/01. It is impossible at this juncture to know how much of the WTC damage was attributable to fire alone. But even without knowing the exact figure, we can all posit it was substantial. While we believe TRIA affords protection to insurers for this peril, the following three items should be contemplated for this residual liability.

- *Pricing*

In most cases, regulators will be looking for the captive to price the cover in line with what is available in the traditional marketplace. Some regulators may be more or less strict on this issue, but under pricing the coverage significantly could lead to a backlash, perhaps even from Treasury.

- *Funding of the Captive's Retention under TRIA*

For 2003, the captive retains an amount equal to 7% of its 2002 direct earned premium. For 2004 and 2005 (if the Act is extended for its final year), this retention rises to 10% and 15%, respectively, of the prior year's direct earned premium. Where an insurer has not been in business for the full calendar year prior, the interim guidance says the following:

"...To administer...newly formed insurers in a manner that is consistent with other insurers...and to prevent newly formed insurers from having the unfair advantage of lower relative deductibles Treasury intends to propose that the deductible measure for new companies formed after...November 26...will be based on contemporaneous data for direct earned premium that corresponds to the current Program Year."

As an example, if a captive is established in 2003 with projected direct earned premium for that year of \$10 million, then it is reasonable to assume its retention for purposes of a TRIA loss occurring in 2003 would be \$700,000.

In most cases, this retention will be manageable within the captive's capital base.

- *Coinsurance Under TRIA*

For the term of the program, each insurer also coinsures 10% of losses it incurs above its retention. This has to be borne in mind when the limit of coverage is set. As an example, if the captive provides \$500 million in certified terrorism cover, it could retain as much as \$50 million that is not recoverable from the government backstop.

Regulators may look closely at the capital available to the captive for this item. Where capital is insufficient, but the sponsor company's financials are favorable, regulators may require nothing more than a cut-through to the sponsor, an agreement that should a loss occur the sponsor will inject sufficient capital to protect the captive's position. This, however, could have perils of its own if it becomes evident that the insured is not really transferring risk to the captive.

Of course, this coinsurance position can be protected by a facultative reinsurance placement in the stand-alone terrorism market. This has the up-side of operating like a more traditional market by purchasing reinsurance protection but the down-side may be its cost.

- *Security Rating Requirements of Lenders*

Few captives have AM Best or other financial ratings. Therefore, their use for providing certified terrorism may be limited where lenders and other financially interested parties are demanding the coverage be purchased. It might be possible to arrange a double-trigger guarantee program with an appropriately rated insurer, but the costs of this may be counter-productive.

- *Claim Reimbursement under TRIA*

Treasury has not yet issued guidelines for claims reimbursement under the Act. Therefore, it is not clear how and when captives would receive the benefits of the

government backstop in the event of an insured loss. Nor is it yet clear what procedures Treasury may set out regarding “reasonable procedures” to be followed by the insurer for processing claims. It is safe to say that such procedures will ensure that claims are sufficiently investigated and audited to ensure that conflicts of interest between a captive and its insured are avoided.

We understand that some parties are suggesting that captives be formed for the sole purposes of providing terrorism coverage at the lower end of the commercial pricing spectrum. We urge caution in this regard for the following reasons:

It can be argued that captives set up to provide “cheap” access to the government backstop do not further some of the specified purposes of the Act, namely, to assist in creating a stable long-term traditional market for terrorism coverage, which endures following the expiration of the Act. The marketplace cannot build capacity unless capital flows into it. And there is little likelihood that a captive would consider providing this cover in the absence of the government backstop.

We are aware that Treasury is reviewing a number of issues relating to captives that may be addressed in its final regulations on TRIA and these regulations may have bearing on your decision on captive utilization.

Our advice at this juncture is that if a captive existed at November 26 and is eligible under the Act, it should consider itself at risk and comply immediately with the notification requirements of the Act. In the absence of its insured’s declination of same, the meter is running on its liability for certified terrorism. Whether that insured chooses or not to accept the mandatory offer of insurance is a matter of corporate financial review including how the coinsurance requirements can be met through funding or reinsurance. Remember that fire following is not optional, nor can it be sublimated in many jurisdictions. So even if certified terrorism is rejected by the insured, the captive is at risk for fire following for both its retention and its coinsurance. How this risk is funded should be a continuing concern.

As for setting up captives for TRIA-access purposes only, until Treasury issues its final regulations, or at least until it addresses captives more fully, we suggest you review the use of your captive with caution.

For further information, please contact your Willis Client Advocate or Guy Ragosta and his team at Willis Captive Management.

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