

As we enter the second full year of TRIA (the Terrorism Risk Insurance Act of 2002), it seems an appropriate time to review some basic facts and to outline why 2004 may prove a pivotal year for TRIA vis-à-vis Property placements.

A Review of the Facts

- TRIA went into effect November 26, 2002 and the protection (known as TRIP) provided to "qualified insurers" remains in effect through December 31, 2005.
- The Act applies only to losses arising from "certified acts of terrorism" that exceed \$5 million on an aggregate basis in any one event. In order to be covered by TRIA, a loss must be caused by an act certified as "terrorism" by the Secretary of the Treasury, the Secretary of State and the Attorney General.
- TRIA establishes a cap of \$100 billion on liability for insured losses in any one calendar year. If aggregate losses were to exceed this amount, Treasury would determine the pro-ration of this limit.
- All of the following criteria must be met for an incident to be certified as terrorism:
 1. The incident must be violent or dangerous to human life, property or infrastructure.
 2. Damage must occur to property located within the US (including US territories, possessions and US territorial waters) or to US air carriers or vessels regardless of location.
 3. The incident must be committed by or on behalf of a foreign person or foreign interest as part of an effort to coerce the

US civilian population or to influence the policy or affect the conduct of the US government.

- "Eligible insurers" are :
 1. All insurers licensed or admitted in *any* state
 2. Insurers not licensed or admitted but who are eligible surplus lines insurers on the NAIC listing of Alien Insurers
 3. Assigned risk plans and other residual market pools and state workers' compensation funds
 4. Entities approved to offer Property and Casualty insurance by a federal agency in connection with maritime, energy or aviation activity

Captives and risk retention groups are eligible if they meet the first criterion **and** write commercial Property or Casualty coverage on a direct basis **and** report direct earned premiums.

- Eligible lines of business covered are all commercial Property and Casualty lines excluding: crop or livestock insurance, private mortgage insurance, financial guaranty insurance, medical malpractice insurance, health or life insurance and flood insurance.
- All "eligible insurers" **must participate** in the TRIA program. To qualify for the Act's protection and avoid fines, they must:
 1. Notify policyholders of the federal government's potential share of "certified terrorism" losses.
 2. Make "certified terrorism" coverage available and advise its cost.



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Policyholders have no obligation to accept this offer of coverage, which may not "differ materially from the terms, amounts, and other coverage limitations applicable to losses arising from events other than acts of 'certified terrorism.'" If the offer is made and then rejected, the insurer and the policyholder are free to negotiate other terms.

- In 2004, "eligible insurers" must retain an amount equal to 10 percent of their 2003 direct earned premium before they are eligible for TRIP. In 2005, this rises to 15 percent of 2004 premium. Above this amount, they coinsure 10 percent of any loss.
- TRIA does not regulate rates nor does it override the authority of state insurance commissioners to regulate rates.
- The Act allows the federal government to recover a portion of its losses through premium surcharges. These "may not exceed, on an annual basis, the amount equal to three percent of the premium charged" for eligible lines of business. Such surcharges are to be passed on to all policyholders, whether or not they purchase "certified terrorism" coverage.

Observations

Buyers saw tangible moderation in TRIA pricing in Property programs over the course of 2003. This may be attributable to 1) the absence of any "certified terrorism" events, 2) a better understanding of the retention impact (seven percent for the year) and/or 3) assumption of some of the retention or coinsurance risk by reinsurers. Further, many insurers made non-



certified coverage available for a minimal premium charge when purchased alongside "certified terrorism." (None made it available without the purchase of TRIA.) We now regularly advise clients to identify what they are willing to pay for these coverages to "help" underwriters arrive at consistent and attractive pricing.

These conditions seem to have stirred competitive forces in the Stand-Alone Terrorism market, which, too, has seen moderating rates. This market is certainly no longer the only game in town, at least for US-situated risks.

It is important to note the difference between covering US terrorism as part of the Property program and with Stand-Alone markets.

- Coverage under Property programs more closely (sometimes exactly) mirrors terms and conditions of the policy contract in areas such as Contingent Time Element, Service Interruption, Civil Authority and Ingress/Egress. However, it does not extend beyond the US, its territories and possessions.
- Coverage under Stand-Alone policies is normally a narrower, "pure vanilla," coverage, e.g., Property Damage and Direct Business Interruption/Extra Expense with few extensions (at least to date). However, it can cover exposures worldwide.

Neither option responds, however, in two important areas: nuclear, biological or chemical contamination (NBC), and cyber terrorism. Recently, some "ink" has been given to these gaps, but the fact remains that 1) neither NBC nor cyber coverage was widely available under Property programs prior to 9/11 (and therefore neither are mandated by TRIA) and 2) insurers still insist they cannot model their aggregations appropriately and therefore cannot afford coverage for either.

On cyber terrorism, insurers can further argue that we have actually witnessed incidents of this in 2003 and 2004, e.g., SoBig.F and MyDoom, and that the resulting damage reportedly has been disastrous. *Yet none of these has been certified as a terrorism act under TRIA.* Therefore, if an insurer provides coverage for such events, it might reasonably assume it is going it alone, likely without TRIP or treaty support.

The Captive Solution

Some corporations have turned to captives, either new or existing (but always qualified as "eligible insurers"), to cure the ills they have encountered in the traditional markets, whether Property or Stand-Alone. These ills include inconsistent/unacceptable pricing, lack of global reach and lack of breadth of coverage. The captive option is clearly an attractive one.

Since there is no traditional source of NBC or cyber terrorism coverage, a captive may be the only option, at least within the US, its territories and possessions, for “certified acts of terrorism.” For those captives that take on these risks, however, there is no reinsurance available either for their retention or for the coinsurance participation for these perils, although the Stand-Alone market can protect the captive for other circumstances. Certain corporations have chosen to retain NBC and cyber terrorism risks in their captives, determining it is better to have 90 percent protection above that retention than to be 100 percent uninsured.

The challenges for a captive deepen, however, depending on its sponsor’s circumstances. Chief among these challenges are:

- How to handle “non-certified events” within the US
- How to handle terrorism outside the US

Most captives do not want to retain these risks entirely and so they seek reinsurance in the Stand-Alone market. Again, that market has limitations on coverage that create potential gaps for the captive. To write a policy concurrent with these limitations (and curtail coverage for its parent) or to retain the differences in conditions for its own account – that is the question captives face. And it is one that needs to be considered carefully.

An alternative is for the captive to issue a Property policy with TRIA-only coverage, and then either purchase direct Stand-Alone coverage for the remainder of its terrorism risks or issue a separate policy and reinsure to the Stand-Alone market on an identical form. The latter seems an unnecessary administrative burden with no tangible benefit to the parent company, so we do not recommend it.

One of the unresolved issues with the approach above is the uncertain liability a captive assumes 1) by excluding non-certified terrorism in states where, in theory, this is not permitted and/or 2) through the operation of fire-following terrorism regulations in states that otherwise permit terrorism to be excluded.

Another issue for captives – indeed for all insurers – is the timing of their payments on “certified terrorism” claims versus the timing of TRIP reimbursement. In its most recent Proposed Rules, Treasury has suggested that reimbursements should follow traditional reinsurance procedures: “as soon as possible” after receipt of necessary documentation from an insurer that a claim has been paid, and if interval payments are made by an insurer, via successive bordereaux. Further, Treasury has suggested “payments shall be made in such installments and on such conditions as determined by Treasury to be appropriate.” At least

one captive association has challenged Treasury on this, noting that captive reinsurance procedures call for simultaneous payments, i.e., the reinsurer reimburses the captive at the same time the captive pays the original policyholder. To have to pay a claim and then wait for reimbursement would clearly require a change in capital structure that would be detrimental to a captive.

Whether Treasury will choose to single out a group of insurers for special claims treatment has yet to be seen. **We encourage captive owners to contact their captive associations on this important issue.**

Even if insurers must continue to “make cover available” past December 31, 2004, the question then becomes until when?

A Crucial Decision

Treasury has distributed questionnaires to policyholders and insurers (though not to agents/brokers) in an attempt to prepare for a crucial decision that must be made by September 2004: whether to require insurers to “continue to make ‘certified terrorism’ coverage available” in 2005. What does this mean? Not much if they decide in the affirmative. But if they decide that coverage must no longer be made available? Another story. We will enter 2005 with an “eligible insurer” community that faces retentions of 15 percent of their 2004 direct earned premium (a five percent increase over the current amount, in a market likely to produce declining premium income in 2005). If these markets don’t have to make the cover available, will they? It is true they will still be protected by TRIP, but only above their (increased) retention and only for 90 percent of that excess. For some insurers, the increase in retention can be viewed as material – and if not protected by reinsurance, perhaps life-threatening. In similar circumstances, would you make something as volatile as “certified terrorism” available if not required to do so? Questionable. We also encourage corporations to speak out on this issue.



Even if insurers must continue to “make cover available” past December 31, 2004, the question then becomes until when? TRIP expires on December 31, 2005, unless Treasury recommends, and Congress enacts, an extension of the Act. The word on the street is there will be limited appetite to extend it – unless a “certified terrorism” event intervenes. So in theory, a policyholder could renew coverage for a year on June 1, 2005 and have “certified terrorism” protection only through year-end.

Thoughts

The willingness and *ability* of reinsurance markets to assume the US government’s role as reinsurer of last resort when TRIP expires is unknown. The Act mandates an annual cap of \$100 billion on all liabilities on eligible commercial lines of coverage. But the global re/insurance community is unlikely to be able to impose such a cap because of regulatory and consumer charges of a cartel. We believe there is reason to be concerned, at least on the Property side, past 2005.

We will continue to update you during this critical period.



Willis TRIA Working Group

The Willis TRIA Working Group regularly brings together experts from our insurance, reinsurance, captive, legal and other departments in seven cities and three countries. Their joint recommendations and insights are relayed to Willis Client Advocates across the world as well as to readers of this publication.

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