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THE TERRORISM RISK INSURANCE EXTENSION ACT OF 2005 EXTENDS THE FEDERAL TERRORISM RISK INSURANCE PROGRAM TO DECEMBER 31, 2007

January 1, 2006

On December 22, 2005, President Bush signed into law the Terrorism Risk Insurance Extension Act of 2005, P.L. 109-144 (the "Extension Act"), which extends through the end of 2007 the terrorism risk insurance program initiated by the Terrorism Risk Insurance Act of 2002.

The U.S. Department of Treasury issued Interim Guidance on these TRIA amendments on December 29, 2005 (the "Interim Guidance"). The provisions of the Interim Guidance are effective until such time as Treasury may issue regulations implementing the amendments.

In general, the Extension Act preserves the existing TRIA program, including the requirement that property and casualty insurers offer terrorism coverage to their insureds and the provision for quota share payments by the federal government to participating insurers in the event of a terrorism loss. But the Extension Act includes some important changes that any insurer subject to TRIA (including captive insurers domiciled in the United States) should understand.

To summarize the key provisions of the Extension Act and Interim Guidance:

1. Requirement to "make available" terrorism coverage. Insurers must make terrorism coverage available to their insureds for any policy issued or renewed during 2006 and 2007 (but there is no requirement that the coverage extend for acts of terrorism occurring after December 31, 2007). The Extension Act has modified the definition of "commercial property and casualty insurance" for terrorism coverage effective January 1, 2006 and after. These changes may effectively exempt an insurance company from the definition of "insurer" for purposes of TRIA, if the insurer offers only lines of coverage previously included in TRIA but now excluded as a result of the Extension Act. (See paragraph 3, below.)

2. Compliance with the "make available" requirement. The Interim Guidance specifically addresses the requirement that insurers "make available" terrorism coverage appropriately for periods on and after January 1, 2006:

- **if the insurer offered terrorism coverage for the entire term of the policy (i.e., extending into 2006), or if the insured declined terrorism coverage for all or any part of the policy term, the insurer is not required to make a new offer of terrorism**

coverage. This includes: (i) policies that were issued or renewed during 2005 with terrorism coverage extending into 2006 conditioned only on the extension of TRIA into 2006, such that the terrorism coverage automatically took effect with extension of TRIA; and (ii) policies in which the insured declined the terrorism coverage, even if the terrorism coverage would have expired on December 31, 2005 if it had been accepted.

- **if the insured was offered, and accepted, terrorism coverage that did not extend past December 31, 2005, the insurer must make a new offer of terrorism coverage on or before January 31, 2006.** This applies to: (i) policies that were issued or renewed during 2005 and extending into 2006 in which terrorism coverage expired as of December 31, 2005; and (ii) policies effective on or after January 1, 2006, under which the offer and negotiation of the terms of coverage occurred before the Extension Act was enacted, and were done without an offer of terrorism coverage.
- **insurers may continue to use the NAIC model forms to offer terrorism coverage.** Treasury notes, however, that the wording of the forms may be modified consistent with the changes in the Extension Act.

3. Covered lines of insurance. The Extension Act changes the definition of “commercial property and casualty insurance coverage,” with respect to which an insurer must offer terrorism coverage. A number of lines of coverage are now excluded from this definition for coverage in effect on and after January 1, 2006. The Interim Guidance describes these lines by reference to Statutory Page 14 of the NAIC Annual Statement. These are:

- Line 3 – Farmowners Multiple Peril
- Line 19.3 – Commercial Auto No-Fault (personal injury protection)
- Line 19.4 – Other Commercial Auto Liability
- Line 21.2 – Commercial Auto Physical Damage
- Line 26 – Burglary and Theft
- Line 24 – Surety
- Professional Liability Insurance as reported on Line 17 – Other Liability.

For this purpose, Treasury defines “professional liability insurance” as “coverage available to pay for liability arising out of the performance of professional or business duties related to an occupation, with coverage being tailored to the needs of the specific occupation. Examples include abstracters, accountants, insurance adjusters, architects, engineers, insurance agents and brokers, lawyers, real estate agents and stockbrokers.” This definition is taken from the Uniform Property & Casualty Coding Matrix used by the System for Electronic Rate and Form Filing (“SERFF”) sponsored by the NAIC.

Directors and Officers liability coverage is now specifically included as a “commercial property and casualty insurance coverage.” Premium for this coverage is reported under Line 17 – Other Liability on the NAIC Annual Statement.

4. Change in the Federal Share of Compensation for Insured Losses. The Extension Act extends the TRIA program of federal government reimbursement payments to insurers to cover a portion of insured losses that result from an act of terrorism occurring on or before December 31, 2007. Such payments are the “federal share of compensation for insured losses.”

The definition of “act of terrorism” is not changed from the existing definition in TRIA and the Treasury Regulations. An “act of terrorism” is essentially any act of terrorism incurring in the United States, which is caused by foreign actors, is certified by federal officials, and results in aggregate losses of at least \$5 million.

The Extension Act changes the determination of the federal share of compensation for insured losses, by introducing a “Program Trigger”:

- for insured losses resulting from acts of terrorism occurring on or before March 31, 2006, the federal share of compensation for insured losses is the amount equal to 90% of the insurer’s losses that exceed the insurer’s TRIA deductible.
- for insured losses resulting from an act of terrorism occurring after March 31, 2006 and on or before December 31, 2006, the federal share of compensation for insured losses remains at 90% of losses in excess of the TRIA deductible. **These payments by the federal government are not available, however, unless the aggregate of insured losses resulting from the act of terrorism exceeds the Program Trigger of \$50 million.**
- for insured losses resulting from an act of terrorism occurring on or after January 1, 2007 and on or before December 31, 2007, the federal share of compensation for insured losses will equal 85% of losses in excess of the TRIA deductible. **These payments by the federal government are not available unless the aggregate of insured losses resulting from the act of terrorism exceeds the Program Trigger of \$100 million.**

The Program Trigger could significantly increase the exposure of an insurer offering terrorism coverage that qualifies for payment of the federal share of compensation for insured losses. For example, under TRIA prior to the Extension Act, if a insurer provided terrorism coverage for an act of terrorism with limits of \$100 million, the insurer’s maximum exposure for losses resulting from an act of terrorism would have been about \$10 million (10% of the insured loss plus the insurer TRIA deductible). Beginning April 1, 2006, the insurer’s exposure could be significantly increased. For example, if an act of terrorism occurs in September 2006 resulting in an aggregate of \$45 million in insured losses, all of which are covered by the insurer, the insurer will be liable for the full \$45 million in loss without any federal compensation payments.

It is not clear how the commercial market will price terrorism coverage that includes the potential for the insurer to pay the full amount of loss without federal compensation. Captive insurers should determine what, if any, additional capital may be required to continue to write the TRIA coverage.

The Interim Guidance acknowledges that Treasury “is considering whether further rulemaking or guidance is necessary to address issues associated with the new Program Trigger.” The Interim Guidance specifically states that **“insurers should continue to make coverage available for insured losses, although further consideration of issues posed by the new Program Trigger could affect this requirement on a going forward basis.”**

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Based on these statements from Treasury, we believe that insurers must offer terrorism coverage that would include full coverage for losses under the Program Trigger. In other words, it would not seem consistent with TRLA and the Extension Act to exclude or otherwise limit coverage for losses from an act of terrorism that does not reach the Program Trigger. Structuring a policy like this, without further guidance from Treasury, may be deemed an impermissible “gaming” of the TRLA program.

5. Insurer Deductible. The TRIA deductible will continue to increase during 2006 and 2007. In 2006, the insurer deductible will be 17.5% of the insurer’s direct earned premiums written during the immediately preceding calendar year. In 2007 the deductible will be 20% of direct earned premium.

If you have any questions about these or any other captive insurance developments, please contact Kathy Davis or Kevin Moriarty at 802-863-2375, or at www.drm.com.

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