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**SPECIAL REPORT**

## Overview of The Terrorism Risk Insurance Act of 2002

by Christopher Tait, FCAS, MAAA

On November 26, 2002, President Bush signed the Terrorism Risk Insurance Act of 2002 (the Act) into law. The purpose of the Act is to establish a *temporary* Federal program that provides for a system of shared public and private compensation for insured losses resulting from acts of terrorism. Participation is mandatory for all entities that meet the Act's definition of an insurer. A copy of the Act can be found at:

<http://news.findlaw.com/wp/docs/insurance/tria112602.pdf>

### Insurer Requirements

All terrorism exclusions in property and casualty insurance contracts that were in force on November 26, 2002 are now void. Any state approvals of terrorism exclusions are also void. Insurers may reinstate terrorism exclusions, but only if:

- the insurer has received a written statement from the insured that affirmatively authorizes such reinstatement; or
- the insured fails to pay any increased premium charged for providing such terrorism coverage, as long as the insurer provided notice of the increased premium at least 30 days prior to any such reinstatement.

Each entity that meets the Act's definition of an insurer must now make terrorism coverage available that does *not* differ materially from the terms, amounts, and other coverage limitations applicable to other types of losses. Until December 31, 2003, rates and forms for terrorism risk insurance will not be subject to prior approval or a waiting period, but nothing in the Act affects the ability of any state to invalidate a rate as being excessive, inadequate, or unfairly discriminatory.

Insurers must provide a clear and conspicuous disclosure to their policyholders of the premium charged for "insured losses" covered by the program and the Federal share of compensation for insured losses under the program. The timetable for such disclosure is:

- For policies issued prior to November 26, 2002, disclosure must be made on or before February 24, 2003 (i.e., within 90 days of enactment).

- For policies issued between November 27, 2002 and February 24, 2003, disclosure must be made at the time of offer, purchase, and renewal of the policy.
- For policies issued after February 24, 2003, disclosure must be made on a separate line item in the policy, at the time of offer, purchase, and renewal of the policy.

The NAIC has drafted a Model Bulletin to assist insurance carriers and regulators in complying with the requirements of the Act. Draft policyholder disclosure forms can be found at:

<http://www.naic.org/pressroom/releases/EmergencyResponse.htm>

The Secretary of the Treasury (the Secretary) will issue regulations, as soon as practicable, that apply the provisions of the Act to state residual market insurance entities and state workers' compensation funds. The Secretary may, in consultation with the NAIC and state regulators, apply the provisions of the Act to other classes or types of captive insurers and self-insurers.

### Property and Casualty Coverage Affected

The term "act of terrorism" is defined to be any act that is certified by the Secretary, in concurrence with the Secretary of State and Attorney General of the US to meet certain conditions (specified in the Act).

To qualify as an act of terrorism, the resulting property and casualty insurance losses must exceed \$5,000,000 in the aggregate. 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. The term "property and casualty insurance" means *commercial lines* of property and casualty insurance, including excess insurance, workers' compensation, and surety. It does not include:

- Federal crop insurance
- Private mortgage insurance
- Financial guaranty insurance
- Medical malpractice
- Health or life insurance

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- Flood insurance
- Reinsurance or retrocessional insurance

Although the program does not cover reinsurance, the Act does not limit or prevent insurers from obtaining reinsurance coverage for the individual insurer deductible losses or the retained portion of any insured losses. Obtaining reinsurance coverage does not affect the calculation of such deductibles or retentions.

### Deductibles/Federal Share of Compensation

Each insurer has a separate “deductible” in the event of an act of terrorism, which is based on a percentage of that insurer’s direct earned premium (DEP) in the calendar year prior to the start of each program year. The deductibles are as follows:

- *Transition Period* (November 26, 2002 – December 31, 2002) = 1% of DEP for November 27, 2001 through November 26, 2002
- *Program Year 1* (January 1 – December 31, 2003) = 7% of 2002 DEP
- *Program Year 2* (January 1 – December 31, 2004) = 10% of 2003 DEP
- *Program Year 3* (January 1 – December 31, 2005) = 15% of 2004 DEP

If an insurer has not had a full year of operations during a calendar year, the Secretary will determine the applicable portion of DEP.

The Federal share of compensation under the program is 90% of insured losses above the insurer deductibles (i.e., the insurer is responsible for the remaining 10%). Total insured losses will be capped at \$100.0 billion per program year. If insurance industry retained losses are less than the insurance marketplace aggregate retention amounts (\$10.0 billion in Year 1, \$12.5 billion in Year 2, \$15.0 billion in Year 3), the Secretary will recoup the difference through an industry-wide premium surcharge (i.e., a terrorism loss risk-spreading premium) not to exceed 3%.

Thus, coverage under the program is subject to aggregate insurance industry retention, individual insurer deductibles, a 10% coinsurance provision, and a \$100.0 billion maximum on insured losses per program year.

Any determination of the Secretary will be final and not subject to judicial review. The Secretary may assess a civil monetary penalty

(minimum penalty = \$1,000,000) against any insurer that the Secretary determines:

- has failed to charge, collect, or remit terrorism loss risk-spreading premiums,
- has intentionally provided erroneous information regarding premium or loss amounts, or
- submits fraudulent claims.

If an act of terrorism has occurred, there will be an exclusive *Federal* cause of action for any resulting property damage, personal injury, or death. All state causes of action are preempted. The Judicial Panel on Multidistrict Litigation will designate one or more US district courts that will have original and exclusive jurisdiction over all actions for any claims. According to President Bush, one of the benefits of this provision is that, “lawyers will be prevented from shopping for courts with a reputation for outrageous awards.”<sup>1</sup>

### Outstanding Issues

- How will insurers set prices for terrorism risk insurance?
- Will insurers still be exposed to losses from terrorist actions that do not have the Federal backstop in place (e.g., domestic terrorism)?
- Until the regulations are promulgated, how long it will take for insurers to be reimbursed for an “insured loss”?
- If the US declares war against another country, will actions by citizens of those countries be considered “acts of terrorism”?
- How will rating agencies react to insurers with large exposure to acts of terrorism?

Standard & Poor’s (S&P) has said that, by mandating the adoption of terrorism risk by US commercial property-casualty insurers, the Act “casts a shadow on ratings prospects” and compounds S&P’s negative outlook on the industry.<sup>2</sup>

<sup>1</sup> NU Online News Service, November 26, 2002, 10:37 a.m. EST

<sup>2</sup> NU Online News Service, November 26, 2002, 2:04 p.m. EST

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