



## **SUMMARY OF THE TERRORISM RISK INSURANCE ACT OF 2002**

**Updated December 17, 2002**

This Memorandum regarding the Terrorism Risk Insurance Act of 2002 is not intended to provide specific advice about individual legal, business or other questions. It was prepared solely for use as a guide, and is not a recommendation that a particular course of action be followed. If specific legal or other expert advice is required or desired, the services of an appropriate, competent professional, such as an attorney, should be sought.

### **Background and Purpose of this Summary**

The Terrorism Risk Insurance Act of 2002 (Act) was passed by Congress on November 19, 2002 and signed into law by President Bush on November 26, 2002. The Act provides a federal backstop for certain acts of terrorism via a temporary federal program for sharing with the insurance industry the risk of loss from foreign terrorist attacks. This federal backstop program is designed to “protect consumers by addressing market disruptions and ensure the continued widespread availability and affordability of property and casualty insurance for terrorism risk” and “allow for a transitional period for the private markets to stabilize, resume pricing of such insurance, and build capacity to absorb any future losses, while preserving State insurance regulation and consumer protections.”

The purpose of this summary is to provide an overview of the major features of the Act and to consider some of the issues related to its implementation. Since the Treasury Department has not yet promulgated final regulations, and advisory industry organizations, such as ISO and AAIS, have not yet introduced new rules for underwriting these exposures, there are some unanswered questions. IIABA will continue to monitor regulatory and marketplace developments. A copy of the Act and updated information about it are available in a special terrorism resource section on [independentagent.com](http://independentagent.com), by selecting Terrorism Insurance Info.

### **I. Does the Act Cover Independent Insurance Agents?**

The Act does not impose any duties or responsibilities on independent insurance agents. However, agents may have a role in working with insurers on their compliance with the Act since agents often are the first or primary point of contact for policyholders. Information on possible ways agents may be involved in working with insurers on their compliance with the Act is addressed below in Section II.

### **II. What is the Role of Independent Insurance Agents under the Act?**

As noted above in Section I., the Act does not impose any duties or responsibilities on independent insurance agents. However, agents may have a role in working with insurers on their compliance because agents often are the first or primary point of contact for policyholders. Thus, insurers may want to look to agents to provide the notices of: (i) the premium charges for insured losses covered by the federal backstop Program

and federal government share of compensation for insured losses (See Section XII.); or (ii) the notices that allow insurers to exclude coverage for acts of terrorism (See Section XIII.).

Agents can use forms and information provided by the insurers they represent to provide such notices when requested. This is most likely to occur at the time of an offer or purchase of a policy, and on renewals of policies that are agent-billed.

### **III. What are “Acts of Terrorism” under the Act?**

The Act is triggered when the Secretary of the Treasury, in concurrence with the Secretary of State and Attorney General, certifies an event as an “act of terrorism.” To be certified as an “act of terrorism,” the act must:

- Be violent or dangerous to human life, property, or infrastructure;
- Result in damage within the U.S., (or outside the U.S. in the case of certain air carriers, vessels or U.S. missions); and
- Be committed by someone acting on behalf of a foreign person or interest, as part of an effort to coerce the civilian population of the U.S. or to influence the policy or affect the conduct of the U.S. government by coercion.

**An act is NOT an act of terrorism under the Act if:**

- It is committed as part of the course of a war declared by Congress (except that this exclusion does not apply to workers’ compensation claims);
- Property and casualty insurance losses from the act, in the aggregate, do not exceed \$5 million; or
- It is any other occurrence not defined by the Act as an act of terrorism.

### **IV. What Insurers are Covered by the Act?**

For the purpose of the Act, “insurer” means any entity (or corporate affiliate of the entity) that is:

- A licensed or admitted insurer in any state;
- An eligible surplus lines carrier listed on the NAIC Quarterly Listing of Alien Insurers (for more information, go to: <http://www.naic.org/1finance/international-lloyds/index.htm>);
- An insurer approved to offer property and casualty insurance by a federal agency in connection with maritime, energy or aviation activity;
- A state residual insurance entity or state workers’ compensation fund; or

- Any captive or other self-insuring entity approved by the Secretary of the Treasury. (Self-insurance arrangements by municipalities or other entities such as workers' compensation and state workers' compensations insurance pools also may be approved by the Secretary of the Treasury.)

## V. What Lines of Insurance are Covered by the Act?

The Act applies to insured losses from acts of terrorism for primary and excess **commercial lines insurance**, including workers' compensation and bonds. The Act does **NOT** apply to **personal lines**, crop, livestock, mortgage, financial guaranty, medical malpractice, flood, or life and health insurance. The Secretary of the Treasury will conduct studies regarding the advisability of the future inclusion of life insurance and other lines of coverage, including personal lines.

The Act requires that coverage for insured losses for acts of terrorism not differ materially from the terms, amounts, and other coverage limitations applicable to losses arising from events other than acts of terrorism. Thus, to the extent that exclusions or limitations otherwise apply to coverages (e.g., nuclear, flood), it is possible that coverage for acts of terrorism may similarly be excluded or limited.

## VI. What Time Periods are Covered by the Act?

The Act establishes four time periods, each of which is used to calculate the financial obligations of insurers and the federal government under the Act at different times. Those time periods are broken down as follows:

- **Transition Period:** November 26, 2002 to December 31, 2002
- **Program Year 1:** January 1, 2003 to December 31, 2003
- **Program Year 2:** January 1, 2004 to December 31, 2004
- **Program Year 3:** January 1, 2005 to December 31, 2005 (The continuation of the Program in Program Year 3 will be decided by the Treasury Secretary no later than September 1, 2004.)

## VII. How Does Loss Sharing Work under the Act?

The Act does not apply to losses from acts of terrorism that, in the aggregate, do not exceed \$5 million, so carriers will be responsible for such losses in accordance with the terms of their policies.

For losses from acts of terrorism that exceed \$5 million, the following rules apply:

- First \$5 million in losses – paid by insurers
- Losses above \$5 million and up to \$100 billion – insurer pays deductible (per the formula below in Section VII.) and the excess loss above the deductible is paid 10% by insurers and 90% by the federal government
- Losses in excess of \$100 billion – not payable by either the government or insurer (provided that the insurer has paid its deductible).

## VIII. How are Insurer Deductibles Calculated?

Insurer deductibles are calculated as follows:

- **Transition Period** (November 26 – December 31, 2002):  
1% of direct earned premiums from calendar year 2001
- **Program Year 1** (January 1, 2003 – December 31, 2003):  
7% of direct earned premiums from calendar year 2002
- **Program Year 2** (January 1, 2004 – December 31, 2004):  
10% of direct earned premiums from calendar year 2003
- **Program Year 3** (January 1, 2005 – December 31, 2005):  
15% of direct earned premiums from calendar year 2004

## IX. Does the Federal Government get Reimbursed?

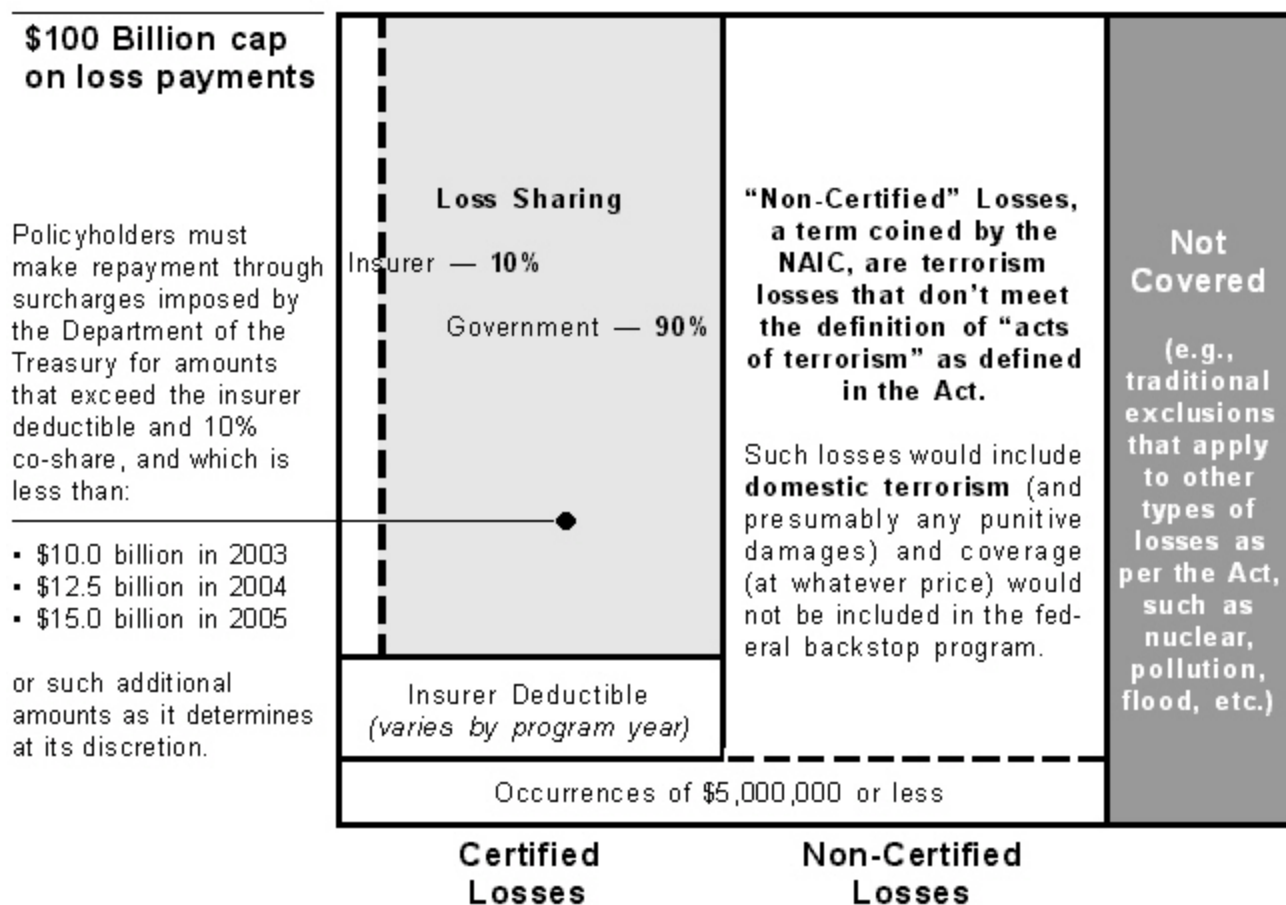
Yes, there is a mandatory recoupment requirement whereby insurers and their policyholders must, in the aggregate, repay the federal government for specified amounts of insured losses based on a formula that varies by Program year. The recoupment formula requires the government to impose surcharges on policyholders to recoup the difference between the aggregate industry/policyholder retention amount for the time period at issue and the aggregate amount of insured losses paid for directly by insurers through application of the per insurer retention requirements and their co-share payments. The annual aggregate retention amounts required of the insurance marketplace are:

- **Transition Period through Program Year 1** (November 26, 2002 – December 31, 2003):  
\$10 billion or the aggregate amount, for all insurers, of all insured losses during such period, whichever is less
- **Program Year 2** (January 1, 2004 – December 31, 2004):  
\$12.5 billion or the aggregate amount, for all insurers, of insured losses during this period, whichever is less
- **Program Year 3** (January 1, 2005 – December 31, 2005):  
\$15 billion or the aggregate amount, for all insurers, of insured losses during this period, whichever is less

The mandatory recoupment by the federal government will be funded by a policy surcharge of up to a 3% terrorism loss risk-spreading premium on commercial lines property and casualty policies.

The easiest way to illustrate how the recoupment requirement operates is an example. Assume that insured losses related to foreign acts of terrorism in 2003 total \$20 billion, that insurer retentions total \$5 billion and that insurer co-pays total \$1.5 billion. The Department of the Treasury is required to impose policyholder surcharges sufficient to collect \$3.5 billion (\$10 billion less the \$6.5 billion in insurer payments related to insured losses) and it also has the discretion, but is not required, to impose policyholder surcharges to collect some or all of the other \$10 billion in federal government payments under the Program.

## Chart of Loss Sharing



## X. Can Insurers Charge for Coverage for Acts of Terrorism?

Yes, the Act permits insurers to charge a premium for any terrorism exposures that are insured but not reimbursed by the federal government.

For acts of terrorism covered by the Act, the rates and forms applied to individual properties and classes of exposures are not subject to prior approval or waiting periods under state laws, however: (i) rate filings that are determined to be excessive, inadequate or unfairly discriminatory can still be nullified by states; and (ii) forms previously subject to prior approval by states are now subject only to subsequent review.

## **XI. What are the Penalties for Non-compliance with the Act?**

The Treasury Secretary's certification of, or determination not to certify, an act as an act of terrorism, is final and not subject to judicial review. It can be anticipated that ISO and/or insurers will implement punitive damage exclusion endorsements where permitted by law. If an act of terrorism has been certified, a federal cause of action is the exclusive remedy for property damage, personal injury or death, and the applicable law is the law of the state in which the act of terrorism occurred. Any punitive damages awarded in such litigation for acts of terrorism shall not count as insured losses under the Act.

In addition, the Treasury Secretary has authority to assess a monetary penalty against any insurer that fails to charge, collect or remit terrorism loss risk-spreading premiums; intentionally provides erroneous premium or loss information; submits fraudulent claims; or otherwise fails to comply with the Act or regulations issued under it. The amount of such a civil penalty can be \$1 million and, in the case of a failure to charge, collect or remit premiums, the civil penalty can be the amount in dispute if it is more than \$1 million.

## **XII. How and When are Policyholders Notified of the Availability and Cost of Coverage for Acts of Terrorism?**

Insurers must clearly and conspicuously disclose to policyholders the premium charged for insured losses covered by the federal backstop Program and the federal government's share of compensation for insured losses, as follows:

- For any policy issued prior to November 26, 2002, notice must be given by February 24, 2003;
- For any policy issued between November 26, 2002 and February 24, 2003, notice must be given at the time of offer, purchase, and renewal of the policy; and
- For any policy issued after February 24, 2003, notice must be given on a separate line item in the policy at the time of offer, purchase, and renewal of the policy.

## **XIII. Can Insurers Reinstate Exclusions for Acts of Terrorism?**

Yes; exclusions for foreign acts of terrorism voided on November 26, 2002 when the Act was signed into law can be reinstated in a commercial lines property and casualty policy in force on November 26, 2002, but **ONLY** if:

- The insurer receives a written statement from the insured authorizing reinstatement of the exclusion; or
- If the insured fails to pay the premium for such coverage and the insurer provided at least 30 days notice before any such reinstatement of: (i) the increased premium for such terrorism coverage; and (ii) the rights of the insured with respect to such coverage, including the date the exclusion would be reinstated if no payment is received.

## **XIV. How Is Agent's E&O Affected by the Act?**

The Act raises two key questions relative to agents' errors and omissions coverage: (1) is there errors and omissions coverage arising from a terrorist event; and (2) can potential claims against an agent be prevented?

Agents should seek guidance from their E&O providers about how they will handle coverage, premium charges, and potential exclusions from E&O policies relating to acts of terrorism. For IIABA members covered by the Big “I” Professional Liability Program through ERC/Westport, a terrorist event does not impact the coverage provided to them under their current E&O policies; the trigger for a loss is a negligent act, error or omission during the rendering of professional services, not the act of terrorism.

ERC/Westport has not made any premium charges in the past for providing E&O coverage arising from terrorism; however, it will comply with the Act by providing E&O policyholders with the clear and conspicuous disclosures required. If ERC/Westport determines that any charges will be imposed, it will apprise its IIABA insureds of any such separate charges on new or renewals of agent E&O policies.

ERC/Westport will provide its agent E&O policyholders with some prevention tips to help mitigate exposure to claims arising from agent actions in assisting insurers with compliance under the Act. Also, IIABA’s Virtual University staff is developing loss prevention materials for the Virtual University and a terrorism module for the IIABA Best Practices of E&O Loss Control Seminar. IIABA’s Virtual University is accessible on [independentagent.com](http://independentagent.com), by selecting Virtual University.

## **XV. Where is there Additional Information about the Act?**

For a complete copy of the Terrorism Risk Insurance Act of 2002, relevant Treasury Department information, NAIC bulletins and model forms, ISO rules/forms analyses, and links to critical information from other sources on this issue, visit the special terrorism section of the IIABA website at [independentagent.com](http://independentagent.com), and select Terrorism Insurance Info.

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