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IMPLEMENTING THE TERRORISM RISK INSURANCE ACT OF 2002

Good afternoon and thank you for inviting Treasury to speak here today on the Terrorism Risk Insurance Act (TRIA) of 2002, or what I guess we all have come to know as TRIA.

I would like to commend the conference organizers for putting together this timely conference on TRIA. The range of topics covered during this conference – for example, assessments of the market for terrorism risk insurance, the impact of TRIA on various forms of insurance, terrorism risk insurance modeling; and an assessment of the reinsurance marketplace – raise important issues that insurers, policyholders, and public policymakers should consider.

Today I will focus my remarks on a couple of areas: a brief explanation of how various parts of Treasury interact in implementing TRIA; where Treasury is in the TRIA implementation process; addressing confusion regarding TRIA; and what issues policymakers need to better understand going forward.

The Structure of Treasury and Implementing TRIA

First, I know that many in the audience have interacted with different parts of Treasury in regard to TRIA. Therefore, I think that it might be useful for me to take a few minutes to explain how different parts of Treasury interact in implementing TRIA.

The primary office at Treasury responsible for overseeing the implementation of TRIA is the Office of the Assistant Secretary for Financial Institutions, which is led by Assistant Secretary Wayne Abernathy. The Deputy Assistant Secretary for Financial Institutions Policy Greg Zerzan also plays a key role in implementing TRIA.

For those in the audience that do not know me, my name is Mario Ugoletti and I am the Deputy Director of the Office of Financial Institutions Policy, which is one of the staff offices that support the Assistant Secretary. The Office of Financial Institutions Policy is a relatively small office - we currently have 8 professional staff members. The responsibilities of the Office include assisting the Assistant Secretary in the development of policies related to all types of financial institutions – insured depository institutions, government sponsored enterprises, insurance companies, securities firms, other types of financial firms – and on pension-related issues.

On a personal note, I have been involved in the development of TRIA from the outset. I worked throughout the legislative process in helping to develop the Administration's position on terrorism risk insurance and ultimately on TRIA. After the signing of TRIA, I have been actively involved in the development of regulations and other aspects of Treasury's implementation of TRIA. The Office of Financial Institutions Policy has also worked closely with Treasury's Office of the General Counsel throughout the implementation process.

On a going forward basis the Office of Financial Institutions Policy will continue to have the primary responsibility of developing policies and regulations regarding the implementation of TRIA.

Many of you may have noticed that Treasury announced the hiring of Jeffrey Bragg as the Executive Director of the Terrorism Risk Insurance Program in March. Jeff brings 25 years of insurance industry experience to this post, including leading the National Flood Insurance Program from 1981-1986. Jeff and his Office will have the primary responsibility of developing the operational aspects of the TRIA. Jeff is in the process of filling out his staff and putting in place the infrastructure to operationally handle potential claims and other aspects of the Program.

Another Treasury Office that many in the audience may be familiar with is the Office of Economic Policy. The Office of Economic Policy has taken the lead in organizing and analyzing information associated with the various study requirements of TRIA, including a study of group life insurance, a study of the potential effects of acts of terrorism on the availability of other lines of coverage outside the scope of TRIA, and a study of the effectiveness of TRIA and the likely capacity of the market after termination of TRIA.

While each Treasury Office has its own primary role in implementing TRIA, of course, we have and will continue to work as a team in the overall implementation and development of policy associated with TRIA and in the development of the Administration's overall policies regarding terrorism risk insurance.

Implementing TRIA

Now I would like to turn to the activity that has occupied the vast majority of my time during the last six months -- and I am sure a fair amount of time of many in the audience -- the implementation of TRIA.

TRIA posed a number of implementation challenges for Treasury. Among the most immediate challenges was the need to act quickly as TRIA became effective immediately on November 26, 2002 when the President signed the bill into law.

In addition to the immediate effective date, the wide range of insurance companies and types of policies that come under TRIA also proved challenging. The range of policyholders that fall under TRIA go from small businesses in rural America to large businesses that operate internationally. Likewise the range of insurance companies that serve these policyholders is just as diverse, and many have their own unique characteristics that do not fit neatly under TRIA.

To assist the insurance industry in complying with TRIA, from December 3 through January 22, Treasury issued three Interim Guidance notices. Issuing Interim Guidance provided Treasury with the ability to respond quickly to implementation issues and to address areas of confusion in a manner that is typically faster than issuing formal regulations.

As most of you know, the next step we undertook was to take the issues that were addressed in the Interim Guidance notices and develop formal regulations implementing TRIA. The February 28 interim final regulation set the groundwork for implementing TRIA by defining key terms used in the statute. The April 18 interim final regulation addressed issues associated with disclosure and make available requirements of TRIA, and the April 18 notice of proposed rulemaking addressed issues associated with the participation of residual market mechanisms under TRIA.

The next step in the rulemaking process is for Treasury to analyze and evaluate the formal comments that were received. Some have asked how long that process takes. I can assure you that Treasury is doing its best to complete the evaluation of the comments in a timely manner, but the actual time it takes to move from an interim final or a notice of proposed rulemaking to a final rule is dependent in part on the comments that we received. If we receive comments that do not raise significant concerns with our approach, the time frame to completion can be relatively fast. In contrast, if we receive comments that do raise concerns with our approach, it can take longer to complete the process.

Despite the substantial input of the insurance industry and other interested parties in the legislative process, the implementation of TRIA has not been an easy task. Even issues that seem straightforward have proved to be complicated. For example, I would guess that most people would have thought that term "commercial property and casualty insurance" would be easily defined. But what we have come to find out is that there really is not a standard definition or reporting requirement for commercial property and casualty insurance. Likewise, other issues such as what it means to be “licensed or admitted to engage in the business of providing primary or excess insurance in any State” or providing TRIA disclosures at the “time of offer, purchase, and renewal of the policy” also have led to questions.

Through interim guidance and the rulemaking process we have strived to provide greater clarity to the insurance industry regarding issues where there may be confusion, and we will continue to do so as we finalize the current rulemakings. Throughout this process, Treasury consulted with and worked closely with the NAIC, and their help has been invaluable in implementing TRIA.

<u>Clarifying Certain Features of TRIA</u>

What I have just described is the general process for clarifying uncertainty regarding TRIA. Treasury issues a regulation or notice of proposed rulemaking, comments are received, we then evaluate and address those comments in finalizing the rulemaking. However, we also have received numerous calls from insurers and policyholders with questions regarding TRIA. While those calls have been falling off in recent months, they do provide insight into where confusion regarding TRIA exists.

One issue where confusion remains is the length of the Program. Some callers have questioned whether the length of the Program is two or three years. I think the confusion arises over the provision in TRIA that requires the Secretary to make a determination no later than September 1, 2004 on whether to extend the "make available" provisions of TRIA into the third year of the Program. TRIA is clear that the Program expires on December 31, 2005, and if a certified act of terrorism was committed prior to December 31, 2005 it would be covered under the Program. In this regard it is the timing of the certified act of terrorism that is key element, not when the policy was written or the length of a particular policy. Claims associated with acts of terrorism committed prior to December 31, 2005 can continue beyond that date, but Treasury does have the discretion to declare when claims associated with an act of terrorism are final.

Another issue where we have seen some confusion is the provision in the definition of act of terrorism that requires that losses total $5 million before an event can be certified as an act of terrorism. We have heard that some policyholders have looked at this provision and concluded that because they do not have $5 million in exposure they have little need for the coverage offered under TRIA. In this regard I think that it is important that policyholders understand that the $5 million threshold is not on a policy-by-policy basis, but rather the threshold is related to aggregate property and casualty insurance losses associated with a particular act of terrorism. For example, if $7 million in aggregate property and casualty insurance losses from a certified act of terrorism were distributed among 10 policyholders, those losses could contribute to an insurance companies ability to access the TRIA backstop, and in turn policyholders should derive some benefit from the TRIA backstop.

We have also had a fair number of questions and have read reports on how captive insurance companies can be used to provide terrorism risk insurance coverage under TRIA. Given the somewhat unique nature of captives and the different types of captive structures a number of operational issues have been raised. We have also heard reports that some captive strategies are being developed to “get around” or “game” TRIA. In particular, I would point to a June 3 BestWire article that describes a number of “gaming” strategies such as charging minimal premiums for high limits. Such “gaming” strategies, whether undertaken by captives or traditional insurance companies, do present a significant concern for Treasury. While Treasury wants to encourage new and sustainable risk sharing mechanisms, we also have an obligation to maintain the integrity of the Program. Treasury will continue to monitor these developments and evaluate whether or not additional rulemaking is necessary to prevent the evasion of insurer deductibles under TRIA.

As I noted earlier, Treasury has strived to clear up confusion through the process of issuing interim guidance and formal regulations. However, even those efforts may not answer questions associated with certain situations. In those special cases, insurers should contact Treasury directly with their questions and we will be implementing a process to better facilitate such inquiries.

We have also stressed throughout the process that insurance companies should follow normal business practices in complying with the requirements of TRIA. We understand that not promulgating specific requirements on certain issues may be different than what most insurance companies have come to expect under State regulation, but we believe that given the temporary nature of TRIA, imposing specific form and process requirements would be counterproductive. TRIA is a temporary program, and Treasury has strived to implement TRIA in a manner that reduces administrative burden both on insurance companies and Treasury, while at the same time ensuring that policyholders are adequately informed.

Implementation Going Forward

Now let me turn briefly to the implementation process going forward. In addition to finalizing the current outstanding rulemakings, Treasury still has a number of areas to address in implementing TRIA. As many of you are aware, Treasury was required to study how the availability of group life insurance and the availability of reinsurance for the group life insurers has been impacted by terrorism risk, and, to determine whether or not group life insurance should be part of the Program. Treasury also must make a determination regarding the participation of self insurance arrangements under Program. Both of these issues raise difficult questions to consider, which is partly why Congress required further study and evaluation by Treasury. While I can not set forth any definite timeline for a decision on these issues, I can assure you that Treasury is carefully considering these issues and we hope to provide additional guidance in the near future.

Other areas that we will be addressing in the coming months include: procedures for claims processing (Sections 103(b) and 104); the development of audit, investigative, and enforcement procedures (Section 104); and the process for implementing any potential recoupment and policy surcharges.

Issues Policymakers Need to Better Understand

I would like to finish up today by raising a few issues that policymakers need to better understand. In addition to implementing TRIA, Treasury is also required to "assess the effectiveness of the Program and the likely capacity of the property and casualty insurance industry to offer insurance for terrorism risk after termination of the Program, and the availability and affordability of such insurance…." TRIA requires that Treasury report to Congress no later than June 30, 2005 on the results of our evaluation of the Act's effectiveness.

To assist in the evaluation of the Act's effectiveness, Treasury is currently developing nationally representative survey instruments for policyholders and insurers. The survey instruments are designed to collect statistically meaningful data on the changes in insurance coverage purchased and premiums for terrorism risk covered by TRIA. Treasury will contract with an established supplier of survey services to conduct the surveys.

The survey instruments will form an important component of Treasury's overall evaluation of the Program, and I strongly encourage insurance companies and policyholders to devote a sufficient amount of time and effort in responding to this survey.

In addition to the formal surveys that Treasury is undertaking, Treasury also continues to consult with the NAIC, and a broad range of experts representing the insurance industry, policy holders, and others. The surveys and consultations, as well as conferences such as this one, serve to highlight key issues that are important to evaluating the effectiveness of the Program and developments in the market for terrorism risk insurance.

One such issue that has been widely reported is that "take up" rates on terrorism risk insurance coverage provided under TRIA are relatively low. If that is the case, it is important that policymakers understand why. Is it because many policyholders see themselves as not having significant risk exposure to acts of terrorism covered under TRIA? Are there structural issues associated with TRIA that has caused policyholders to find the coverage not useful? How has pricing developed, and how does that relate to policyholders choice of purchasing TRIA coverage?

Another issue that is important for policymakers to understand is how the insurance industry's ability to develop additional capacity to manage terrorism risk is progressing. One traditional way insurance companies have addressed capacity issues is through reinsurance. TRIA, at least in part, envisioned the reinsurance returning to the market for terrorism risk through providing coverage for insurance company's deductibles under TRIA. Policymakers need to understand if that has taken place, and if not, what impediments are preventing reinsurers from returning to the market. Other ways insurance companies have traditionally managed issues associated with limited capacity and concentration risk is through risk sharing arrangements. Policymakers need to understand what developments are being considered in this area, and what if any impediments there are to developing such risk sharing arrangements.

We must all remember the basic of goal of TRIA was to develop a temporary backstop for terrorism risk insurance so that private markets would have a chance to adjust. We would encourage insurance companies to think creatively in this regard, and to further consider what methods can be employed to allow for broader private sector involvement in the market for terrorism risk insurance.

Conclusion

In closing, implementing TRIA has proved challenging over the last few months for the Treasury and the insurance industry. We have worked as quickly as possible in dealing the immediate effective date and other time sensitive requirements of TRIA. The Treasury will continue to place a high priority on completing the implementation of TRIA and evaluating how well TRIA is working. We look forward to continuing to work with the NAIC, the insurance industry, and other interested parties as we move forward.