

January 8, 2004

Dear Mr. H

I am writing in response to your electronic correspondence to the Treasury Department regarding the Terrorism Risk Insurance Act (the "Act").¹ In that correspondence you suggest that there may be some ambiguity in the language of Treasury's Final Rule published at 68 FR 41250 (July 11, 2003) regarding the relationship between an insurer's treatment of incidental commercial coverage for purposes of calculating its "direct earned premium" (DEP) and the obligation of Treasury to pay any insured losses arising under that incidental coverage.

We stated in our Final Rule that if a policy includes incidental commercial property and casualty insurance coverage (less than 25% of premium for a hybrid policy), an insurer could elect to allocate the percentage of premium for that incidental commercial coverage as DEP for purposes of establishing the amount of the "insurer deductible" under 31 C.F.R. § 50.5(g). Alternatively (because some insurers expressed concern during the public comment period about the difficulty involved in allocating premiums for certain hybrid policies), Treasury also permitted insurers to elect to exclude any portion of the premium for the incidental commercial coverage of the hybrid policy from its DEP and thus from its insurer deductible calculation. In Treasury's view, the effect of excluding the incidental commercial coverage from the calculation of an insurer's DEP means that the hybrid insurance policy is treated as a non-commercial property and casualty policy and thus is excluded from coverage under the Act. Our view is based in part on the Act's definition of DEP, which is keyed to premiums for *commercial* property and casualty insurance issued by an insurer. Whatever the insurer decides, Treasury intends to use the insurer's decision in determining whether an insured loss is payable under the incidental commercial coverage component of the insurer's hybrid coverage.

As was noted in the preamble to our Final Rule, "Treasury's approach is to maintain a close correlation between the lines of commercial property and casualty insurance eligible for the Federal payment under the Program, and the amount of premiums for those coverages that actually go into calculating an insurer's DEP under the Program."² Following this approach, if an insurer chooses to include a percentage of the premium attributable to incidental commercial property and casualty coverage in calculating its DEP for a hybrid policy that principally involves personal lines or non-Program coverage, then Treasury will share in the insured losses paid by the insurer under the incidental commercial portion of the hybrid coverage, provided all other conditions under the Act and implementing regulations have been met. Conversely, if an insurer does not include the premium attributable to the incidental commercial property and casualty insurance component of a particular hybrid policy from its DEP calculation,

¹ Public Law 107-297, 116 Stat. 2322, 15 USCS § 6701

² 68 FR at 41256.

no Federal payment will be made for an insured loss arising from the incidental commercial coverage.

The basis for this conclusion is that the Federal share of compensation is restricted to payments for “insured losses” under the Act. As you know, the term “insured loss” under 31 C.F.R. § 50.5(e) is defined as losses resulting from an act of terrorism that are covered by primary or excess commercial property and casualty insurance (with certain conditions). Federal payment for an “insured loss” must involve a loss from commercial property and casualty insurance coverage. Treasury considers an insurer’s treatment of premium for DEP purposes binding as to the treatment of its coverage for purposes of defining insured commercial property and casualty losses under the Program.

There is no uniform or consistent definition of commercial property and casualty insurance under State law. Insurers are permitted to determine whether the “commercial” portion of the premium for a hybrid coverage under 31 C.F.R. § 50.5(d) is “incidental”. Treasury has established a method by which insurers may either include or exclude the premium for that coverage from their DEP calculation. Once an insurer makes its choice, it is bound by its decision about the commercial or non-commercial character of the coverage it issues. In other words, both the premium of a hybrid policy for DEP purposes and the coverage of that policy for purposes of receiving Federal payments for insured losses must follow the same characterization of the policy by an insurer.

Thank you for your inquiry. If you have any questions, please do not hesitate to contact me at 202-622-7255.

Sincerely,

David J. Brummond
Legal Counsel
Terrorism Risk Insurance Program