

March 2, 2004

Dear Ms. L:

I am writing in response to your letter in which you requested interpretations concerning the application of the Terrorism Risk Insurance Act of 2002 (the “Act” or “TRIA”)¹ and Treasury’s regulations implementing the Act to three questions raised by your clients, who include captive insurers.²

I. Interpretation of 31 C.F.R. § 50.5(d)(1)(iii)

In your first inquiry, you have presented the following question: if a captive elects to exclude any direct earned premium in the calculation of its insurer deductible (as permitted under Treasury regulations for the types of hybrid policies described in your letter), does the captive still *receive* direct earned premium for purposes of being defined as an “insurer” under the Terrorism Risk Insurance Act? You correctly state that a captive insurer may decide not to include any of its direct earned premium in calculating its insurer deductible if the captive: (1) does not include the premium primarily attributable to non-Program insurance coverage (required to be excluded under 31 C.F.R. §50.5(d)(1)(ii)); and (2) opts to exclude the remaining premium attributable to the policies’ *incidental* commercial property and casualty insurance because it is less than 25 percent of the total direct earned premium (*see* §50.5(d)(1)(iii)).³

To meet the definition of “insurer” under the Act, an entity must “. . . receive direct earned premiums for any type of commercial property and casualty coverage. . . .”⁴ Direct earned premium is defined as “. . . direct earned premium for property and casualty insurance issued by any insurer for insurance against losses [including losses from an act of terrorism] occurring at the locations described in section 102(5)(A) and (B) of the Act.”⁵ By their terms, these definitions include in the definition of “insurer” under the Act those entities that *receive* premiums for commercial property and casualty insurance, including from incidental commercial property and casualty

¹ P.L. 107-297, 116 Stat. 2372, 15 U.S.C. § 6701, *et seq.*

² This response is being issued pursuant to 31 C.F.R. §50.9, which sets forth a procedure whereby persons actually or potentially affected by the Act or regulations may request an interpretation.

³ Treasury adopted its rule permitting the exclusion of premium attributable to incidental commercial property and casualty so that those insurers that did not want to calculate an actual allocation of premiums on small incidental amounts of coverage, and did not intend to perfect their right to recover Federal payment on claims paid on such incidental commercial coverage, could then exclude those premiums from their DEP calculation if they wished to do so.

⁴ P.L. 107-297, Sec. 102(6)(B); 31 C.F.R. §50.5(f)(2).

⁵ P.L. 107-297, Sec. 102(4); 31 C.F.R. §50.5 (published at 68 Fed. Reg. 48,280 (Aug. 13, 2003)).

insurance. No matter how an entity may elect to treat its direct earned premiums for purposes of calculating its insurer deductible under Treasury regulations, it would still qualify as an “insurer” under the Act (assuming the Act’s other criteria are met) because it *receives* direct earned premium within the meaning of the Act’s definition of an “insurer”.

As you noted in your letter, in calculating its insurer deductible under the Program,⁶ an insurer can elect to exclude the direct earned premium it receives from the sale of incidental commercial property and casualty insurance coverage that is provided within a policy that also provides – primarily – personal property and casualty or non-Program insurance.⁷ However, we would like to emphasize that if an insurer elects to avail itself of this option (as permitted by §50.5(d)(1)(iii)), Treasury expects that the insurer should clearly be able to document how premium income was allocated among various coverages.

II. Proposed Stand-Alone Terrorism Policy

Your second inquiry addresses the issue of captives being formed or utilized to provide coverage only for “insured losses”(also sometimes referred to as TRIA-only coverage).⁸

In a notice of proposed rulemaking published at 68 Fed. Reg. 9,815 (Feb. 28, 2003), Treasury solicited public comment on whether it should prescribe other criteria for certain insurers pursuant to its authority under section 102(6)(C) of the Act. In particular, Treasury asked whether criteria should be developed to prevent newly formed insurance companies from participating in the Program if these companies were established for the purpose of evading the Act’s deductible requirements. Treasury explained that “preventing evasion of insurer deductible requirements by special purpose entities formed to provide terrorism risk only coverage” was one objective additional criteria would serve.⁹ In its final rule published at 68 Fed. Reg. 41,250 (Jul. 11, 2003), Treasury explained that it was not proposing additional criteria at that time but that it would continue to monitor developments in the market for terrorism risk insurance and the market’s response to the Act.¹⁰

⁶ Insurer deductible is based on a percentage of the insurer’s previous year’s direct earned premium. *See* 31 C.F.R. §50.5(g).

⁷ 31 C.F.R. §50.5(d)(1)(iii).

⁸ One article has described this as a captive strategy to get around the Act. *See* Terrorism Act Presents New Questions for Captive Market, *Bestwire* (June 3, 2003).

⁹ *Id.* at 9,815.

¹⁰ *Id.* at 41263.

Your letter and others that we have received continue to raise issues surrounding the strategic use of captives as a means of avoiding the requirements of the Act and implementing regulations.¹¹ As a result, Treasury is now again considering future rulemaking to address this issue and several related issues being raised *vis-à-vis* captives.¹²

The *post*-enactment formation or utilization of a captive insurer that will only provide stand-alone, single-risk *TRIA-only* coverage for losses from acts of terrorism raises questions regarding the integrity of the Program. We believe that an entity considering forming a captive insurer for stand-alone, single risk terrorism insurance should be strongly cautioned and advised against undertaking such proposed action if it is doing so in order to avoid the Act's deductible requirements.

III. Eligibility for Payment Question

Your third inquiry relates to the written request by one of your clients, NNN, an association of nonprofit organizations in California, for an interpretation as to whether a specified program would be eligible for federal payments under TRIA. That request is currently under consideration by Treasury.

Thank you for your inquiry. For additional information or if you have any specific questions, please call the Program office at 202-622-6770.

* * *

This response addresses the application of the Act and regulations to the specific situation set forth in your request, as you have represented the facts to Treasury. If there is a change in any of the facts or assumptions presented, and such facts or assumptions are material to a conclusion presented in this response, then the requestor may not rely on that conclusion generally or as support for any proposed or subsequent activity. This response is provided by the Terrorism Risk Insurance Program as a means of stating its current interpretation of the Act and regulations. The Program may revise or revoke this interpretation upon its own initiative or upon the enactment of amendments to the Act or regulations.

TERRORISM RISK INSURANCE PROGRAM

Jeffrey S. Bragg
Executive Director

¹¹ We also noticed that one of your clients recently presented “strategies for captives to avoid the Act’s mandatory participation provisions or to minimize potential post terrorism Act assessments on the captive” at a recent seminar.

¹² Under section 102(6)(C) of the Act, the Secretary may reasonably prescribe other criteria that an entity must meet to qualify as an “insurer” under the Program.