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Terrorism Risk Spurs U.S. Captive Activity

By Thomas P. Stokes



The combination of the federal government's most recent update of its terrorism risk bill and the commercial insurance industry's response to insuring certain terrorism risks has created new opportunities for United States-based captives. Insuring a portion of terrorism risk through a captive potentially creates more effective coverage at a better price than using commercial markets alone.

In this inaugural edition of Towner Perspectives, we will discuss the how's and why's of using a captive to complete your terrorism risk program.

More coverage, more certainty

After September 11, Congress passed the Terrorism Risk Insurance Act (TRIA), providing federal funding for terrorism risk insurance coverage. This coverage created a vital federal backstop that enabled the insurance industry to begin to respond with companion insurance products. Without this legislation, many experts believed both U.S. and global economic interests would have been negatively affected if another terrorist attack occurred. The original law had

a sunset provision, which was extended twice for short periods of time, and only applied to terrorist acts committed from foreign sources.

Uncertainty about whether the Act would be extended and its exclusion of domestic-sourced terrorist acts, such as the bombing of the federal building in Oklahoma City, clouded further commercial development of terrorism risk insurance. However, the latest version of the Act, the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA), extended the sunset provision until 2014 and included coverage for foreign-sourced and, for the first time, domestic-sourced terrorism events on United States soil.

With a more predictable TRIPRA backstop, commercial insurers have since stepped in with innovative products to cover some of what the TRIPRA provisions do not. In concert with a U.S.-domiciled captive, here's how the federal government and commercial insurers work together to assure adequate terrorism capacity.

Elements of TRIPRA coverage

- The Act provides for annual funding of up to \$100 billion for terrorism risk insurance through 2014
- Coverage begins with a triggering event that generates at least \$100 million in total damages. This trigger amount is only used to determine whether TRIPRA will respond to a particular event and shouldn't be confused with TRIPRA's deductible calculation
- When a TRIPRA event occurs, insurers are reimbursed by the federal government after a 20% deductible calculated on the amount of property/casualty premium written in the prior year, not on 20% of the losses incurred
- After the deductible is met, federal reimbursement is calculated at 85% of the remainder, resulting in a 15% co-pay by the insurer
- U.S.-domiciled captive insurers are considered qualified underwriters
- Nuclear, biological, chemical and radiological (NBCR) risks are included as reimbursable losses

Allowing U.S.-domiciled captives direct access to the federal reimbursement provisions gives captive owners the opportunity to maximize their terrorism coverage at very modest cost. As was the intent of the legislation, commercial insurers have responded positively to the use of captives by creating companion products to fine-tune coverage.

**Integrated captive/commercial terrorism insurance generally includes:**

- Wrap coverage that reinsures the captive for unreimbursed losses not paid by federal coverage, such as damages below the trigger amount, deductibles and co-pays
- So-called drop-down coverage, which essentially reimburses insured parties for the amount owed by federal insurance (to the extent of the limits of the commercial policy) if the federal government hasn't responded within a set number of days of submitting a claim. Commercial insurers would then subrogate against the government for reimbursement.

Commercial terrorism risk insurance is not a requirement for accessing the federal backstop, but can broaden coverage and minimize overall exposure. In fact, combining commercial insurance with the federal backstop can help eliminate most terrorism exposure.

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You should note, however, that *commercial insurers will not insure NBCR risks*. This aspect highlights one of the most important reasons to use a captive to insure this risk. Using a captive to access the federal backstop allows a company to obtain critical NBCR coverage when it is not available anywhere else. This is particularly important in any of the hundreds of designated high-risk areas in the country.

US captive domiciles, a good fit

Before talking about how captives can participate in your terrorism risk program, you should understand how domestic domiciles view TRIPRA. While any U.S. captive domicile can be used for underwriting terrorism risk, some, including Vermont, New York, Arizona and Hawaii, have been proactive in making their domiciles available to accommodate TRIPRA. Each domicile develops its own approach to the terrorism risk it allows captives to insure, but virtually all view the federal backstop as a form of reinsurance for the captive and generally do not require capital and surplus adjustments.

The amount of retained risk, however, in the form of the deductible and co-pay, may raise concerns in some domiciles. Depending on where the captive is domiciled, the state may require additional surplus contributions in the form of cash, letter of credit or other assets to minimize the overall exposure of the captive. Vermont, for example, requires that capital and surplus of a terrorism risk program equal at least 10% of any residual risk

retention in the captive after the backstop is taken into account. Some domiciles such as New York suggest, but do not require, additional surplus as long as the parent company is in reasonably stable financial condition.

Your individual situation should be examined to ensure the best domicile match for your captive's needs. This is an evolving process because domiciles can change their positions at any time.

Play by the rules

Care should be exercised, whether using an existing captive or a new entity to access the federal terrorism backstop, as the Treasury Department has expressed concern over using the legislation to take unfair competitive advantage. While Treasury has not responded with further definitions or regulations, it has commented on specific situations and made clear it may question a transaction if:



In a no-loss scenario, the commercial markets keep 100% of the premium paid for coverage.

- The captive is used for the sole purpose of accessing the federal backstop, especially if the captive is created after enactment of the legislation, unless the coverage is an essential part of the captive owner's risk management program and/or unavailable in the commercial markets, or
- The captive is not used in a manner consistent with the common uses of captives.

A number of captive owners have written Treasury about their individual situations, seeking specific approval. In these instances, Treasury indicates its tentative position, but reserves the right to change it in an actual situation. In each case, however, Treasury reinforces the basic reasons it would question a transaction. The current position of the Treasury indicates a thoughtful and methodical approach to accessing the terrorism backstop.

Maximizing coverage:

Our clients establish captive insurance companies for any number of reasons, both to help manage risk and cut costs. The latter aspect is particularly relevant when a captive insurer combines with TRIPRA and commercial insurance, as savings can be significant. The following scenarios look at different approaches to covering terrorism risk.

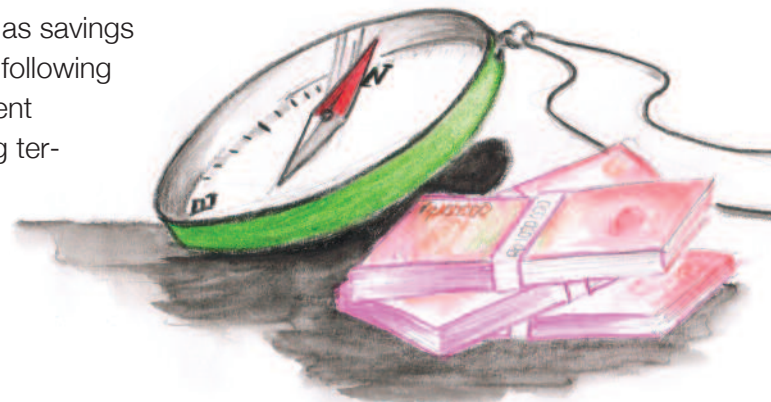
NOTE: Federal reimbursement provisions under TRIPRA apply ONLY to insurance

companies directly underwriting terrorism risk. The only way for a business enterprise to gain benefit is to purchase terrorism insurance from the commercial markets at market prices or to insure the risk in a parent-owned, U.S.-domiciled captive insurance company. Keep in mind, too, that in a no-loss scenario, the commercial markets keep 100% of the premium paid for coverage while as owner of the captive, underwriting profit from the same scenario stays within your commonly owned group.

The first scenario illustrates how the use of a captive compares with purchasing terrorism coverage from a commercial insurer. This scenario highlights the total amount of premium savings that can be achieved. The second scenario illustrates the same facts as the first scenario, but introduces commercial reinsurance products to minimize the overall terrorism exposure.

Scenario I: TRIPRA insurance only in a captive

This example takes into account the TRIPRA federal backstop only. Since



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no primary insurance is involved, it doesn't matter whether the loss is NBCR-related or not. Let's assume that you have or establish a US captive and are exposed to \$1 billion in terrorism-related losses in the US. Where today you have the full \$1.0 billion of exposure, by using your captive you reduce your exposure to just \$150 million, calculated as follows (assuming that the commercial premium for \$1.0 billion in coverage would cost \$500k):

Loss	\$1,000,000,000
Calculate TRIPRA 20% deductible	\$100,000 (20% of \$500k)
Qualified amount equals	\$999,900,000
Government reimburses at 85%	\$849,915,000
The total residual loss payable by the captive for either traditional or NBCR events	\$150,085,000

The examples cited above are purely hypothetical.

Scenario II: TRIPRA and commercial reinsurance using a captive

Now, assume that you have the same \$1.0 billion of commercial terrorism risk and have obtained commercial quotes for traditional coverage, but no commercial insurers will provide coverage for NBCR events. By purchasing commercial reinsurance to cover the deductible and co-pay portions of the risk insured by the captive, the amount of exposure is reduced to zero for traditional terrorism events. Total exposure remains

approximately \$150 million for NBCR events, once again, because the commercial markets have not committed sufficient capacity to such events.

Going this route minimizes the total terrorism exposure (against the original \$1.0 billion) because it insures 100% of that amount for traditional terrorism events and covers approximately \$850 million in potential loss against NBCR events that would not otherwise have been attainable.

These examples assume that an existing captive is used and therefore doesn't include the cost of creating a new one. Implementation costs include a one-time expense to develop the insurance program and capitalize the captive to meet state requirements. By using a letter of credit to fund initial capitalization, new captive costs in New York, for instance, might total around \$100,000. This cost would have to be added to first-year projections. Total captive operating costs in subsequent years would average around \$60,000.

Scenario III Utilize commercial markets only, without using a captive

Of course, you can purchase commercial terrorism coverage for your hypothetical \$1.0 billion in exposure, but you get no chance to recoup the premiums paid for the coverage in a no-loss scenario and are limited by the type (NBCR-related or not) and capacity of coverage that your insurers are willing to allocate to you and your particular location.

Cost comparison among scenarios

Scenario I	Scenario II	Scenario III
Captive Only	Captive/Commercial	Commercial only
Maximizes Savings	Maximizes Coverage	Costliest, Least Coverage
\$85,000	\$125,000	\$550,000

Beyond 2014

These rough examples clearly show how an integrated approach to terrorism risk – of which captive insurance is the foundation – can provide multiple benefits to clients. Thanks to relatively recent developments, these benefits may hold steady for the next few years.

The extension of the terrorism backstop to 2014 provides captive owners with longer-term planning options, while offering Treasury the opportunity to observe developments in the marketplace and potentially enact regulations to clarify its position. The best approach to using a captive, therefore, is to follow the existing direction of Treasury in good faith and monitor developments as they occur.

The current administration in Washington has indicated that it will likely conduct a review of the TRIPRA provisions as part of the overall budget process, but no specific changes have been discussed. While anything can happen, it is likely that the backstop would continue in some

form both to and after 2014, even if deductibles and co-pays etc. were tinkered with. Treasury has stated repeatedly that the purpose of the legislation is to keep the insurance markets – and thereby the broader economy – working in the event of a terrorist attack. It is hard to see how that position might change in the future.

Now is a good time for existing and prospective captive owners to consider the benefits of combining a captive insurance company with the federal backstop and commercial insurance to insure against as much potential terrorism risk as possible.

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