A Role for Captive Insurance Companies after TRIEA?

By William D. Riley

Careful study and consideration are needed as a successor to TRIA is developed.

Under the Terrorism Risk Insurance Act of 2002 (TRIA), the Terrorism Risk Insurance Extension Act of 2005 (TRIEA) and associated U.S. Treasury regulations, captive insurance companies domiciled and licensed in the United States are specifically recognized as "insurers" that must participate in the Terrorism Risk Insurance Program. In the wake of this mandate, captives have assumed an important role in the provision of terrorism insurance to American businesses since 2002.

A full discussion of captive insurance and the role it plays in the Terrorism Risk Insurance Program is available in *TRIA and Captives: The Role of Captive Insurance in the Terrorism Risk Insurance Program*, a white paper published as part of the DRI compendium, *The Future of Terrorism Risk Insurance*. The purpose of this article is to provide updated information on the use of captives to insure terrorism risk and to consider current thinking on the role captives should play, if any, in the post-TRIEA terrorism insurance market.

Current Use of Captives for Terrorism Coverage

Although published information on the subject is scarce, researchers at the Wharton Risk Management and Decision Processes Center have analyzed data provided by the two largest domestic captive domiciles, Vermont and Hawaii, regarding the use of captives to write terrorism coverage. At year-end 2004, approximately 60 Vermont domiciled captives had issued stand-alone terrorism policies providing about $30 billion in total coverage. Information was unavailable from Vermont with respect to captives writing terrorism coverage as part of broader policies covering risks other than terrorism. In Hawaii, 50 captives provided terrorism coverage with combined limits of $2.6 billion. Wharton Risk Management and Decision Process Center, *TRIA and Beyond: Terrorism Risk Financing in the U.S.* (August 2005), at 182–83. In addition to Vermont and Hawaii, captives domiciled in New York, South Carolina, Arizona and likely other U.S domiciles have issued policies covering terrorism risk. It should also be noted that outside of the United States, captives have been used to provide terrorism cover-

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age in countries such as Australia, Austria, France, Germany, the Netherlands, Spain and the United Kingdom. Marsh, Inc., *Marketwatch: Terrorism Insurance 2006* (2006), at 23–24.

With the enactment of TRIEA, some observers anticipated that the statute's revised event trigger mechanism would dampen interest in using captives to cover terrorism risk. Specifically, TRIEA substantially increased the loss levels at which the Federal government becomes obligated to pay for insured losses under the Terrorism Risk Insurance Program. Under the new statutory scheme, Federal payments do not occur until the aggregate industry insured losses from a certified act of terrorism exceed certain "Program Trigger" amounts.

For the period April 1, 2006 through December 31, 2006, aggregate industry losses of at least $50 million were required before any insurer could recover compensation under the Program. For certified terrorist acts occurring in 2007, the applicable "Program Trigger" is $100 million. Despite the implementation of these new trigger amounts, Treasury retains the power to "certify" an act of terrorism if the event results in aggregate insured losses of $5 million or more. As a result, captives writing terrorism coverage face a substantial gap in Federal reinsurance coverage with respect to insured losses that fall between $5 million and the applicable "Program Trigger." Despite these changes, Marsh reports that "the trigger provision ultimately had only a modest negative impact on captive participation" among the substantial number of domestic captives it manages. Marsh, Inc., *Marketwatch: Terrorism Insurance 2006* (2006), at 23. Captives facing this gap in Federal reimbursement coverage have chosen to retain some or all of the risk or purchase private reinsurance, if available.

Finally, it is important to recognize that captives have played a large role in providing coverage for Chemical, Nuclear, Biological and Radiological ("CNBR") events caused by terrorism. Despite the fact that Treasury guidance has confirmed that the TRIA/TRIEA backstop applies to CNBR losses, "CNBR coverage is generally not available in the all risk property market or the standalone terrorism market." Aon Corporation, *Response to U.S. Treasury and President's Working Group: Terrorism Insurance* (April 21, 2006), at 24. In explaining this market failure, Aon notes that "[b]asically, the (re)insurance industry views CNBR event exposure as a 'company killer' where the potential gross aggregate PMR [Probable Maximum Loss] is well in excess of the industry's entire capital base." *Id.* at 26. Marsh observes that "[t]he reluctance of commercial insurers to offer [NBCR] protection means captives are one of the only viable means of securing such protection in meaningful quantities." Marsh, Inc., *Marketwatch: Terrorism Insurance 2006* (2006), at 22.

Findings of the President's Working Group Report

The President's Working Group Report (the "PWG Report") has very little to say about the role played by captives in the terrorism insurance marketplace. In fact, captives are mentioned in the PWG Report only with respect to CNBR coverage. After recognizing the extremely limited nature of the traditional insurance market for CNBR risk, the PWG Report observes that "captives have been promoted as a means of obtaining CNBR coverage at relatively little expense and some coverage in the market may exist as a result." Report of the President's Working Group on Financial Markets, *Terrorism Risk Insurance* (September 2006), at 77. Nevertheless, the report states that "in the long term, captives are unlikely to provide capacity for CNBR coverage without access to a federal reinsurance backstop." *Id.* Despite concluding that "there may be little potential" for future development of the traditional insurance market for CNBR risk, the report provides no analysis or recommendations with respect to the role that captives could play in filling the void.

Conclusion

One of the key conclusions of the PWG Report is that the "presence of subsidized Federal reinsurance through TRIA appears to negatively affect the emergence of private reinsurance capacity because it dilutes demand for private sector reinsurance." Given this statement, coupled with Secretary Henry Paulson's cover letter emphasizing the temporary nature of TRIA, it is not surprising that the PWG Report lacks any substantive analysis of the future role of captives, which depends largely on the continued availability of some form of government backstop or the development of a vastly improved private reinsurance market for such risk. Indeed, the Wharton study notes that it is "probable that the use of captives for terrorism risk would expand significantly if TRIA were made permanent in its current form." Wharton Risk Management and Decision Process Center, *TRIA and Beyond: Terrorism Risk Financing in the U.S.* (August 2005), at 183.

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Whether or not a Federal backstop remains available in the future, captives are likely to play some continued role in the terrorism insurance marketplace, primarily because of the access they provide to traditional reinsurance markets. Indeed, Marsh's reported experience since the passage of TRIEA indicates that many captive owners, through a combination of capital infusions and access to private reinsurance, are using their captives to provide coverage for the layer below TRIEA's event trigger. In any event, it seems likely that some form of Federal involvement will be necessary to develop a comprehensive market for terrorism coverage, most notably with respect to CNBR risk. Given the substantial role that captives currently play in the provision of terrorism coverage, it is important that they be carefully studied and considered during the process of developing a successor to the current Terrorism Risk Insurance Program. FD