Market Bulletin

LLOYD'S

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FROM:	Director, Worldwide Markets
LOCATION:	G12
EXTENSION:	5998
DATE:	22/11/2002
REFERENCE:	Y2917
SUBJECT:	U.S.TERRORISM RISK INSURANCE ACT OF 2002
SUBJECT AREA(S):	Commercial P & C Business
ACTION POINTS:	To note the content of the above Act, its likely implications when enacted and the necessary action market participants need to undertake.
DEADLINE:	Immediate

WHILST THE BILL HAS BEEN PASSED BY THE HOUSE OF REPRESENTATIVES AND THE SENATE, IT HAS NOT YET BEEN SIGNED BY THE PRESIDENT. THIS SUMMARY IS BASED ON INFORMATION TO DATE AND WE ARE AWAITING CLARIFICATION ON DEFINITIONS AND ISSUES ASSOCIATED WITH IMPLEMENTATION. WHEN ENACTED, THE ACT WILL REQUIRE PROMPT ACTION BY INSURERS, INCLUDING LLOYD'S UNDERWRITERS, AND BROKERS. FAILURE TO ACT PROMPTLY MAY INCREASE UNDERWRITERS' EXPOSURES TO DEFINED "ACTS OF TERRORISM". THE PURPOSE OF THIS BULLETIN IS TO ENABLE UNDERWRITERS AND BROKERS TO COMMENCE PREPARATIONS FOR THE ACTION THAT WILL BE REQUIRED. A FURTHER BULLETIN WILL BE ISSUED, ONCE THE BILL IS ENACTED. (THE BILL IS EXPECTED TO BE SIGNED INTO LAW WITHIN THE NEXT TWO WEEKS.)

1. Purpose of bulletin

To advise the market of the U.S. Terrorism Risk Insurance Act of 2002, ("the Act") which, is due to be imminently enacted and will result in immediate significant changes to the exclusion / cover of terrorism risks. The likely implications for underwriters and brokers are summarised, along with recommendations as to the preparatory steps market participants should undertake.

The bulletin applies to both underwriters and brokers dealing with U.S. commercial property and casualty insurance, including marine and aviation business. In certain circumstances the Act will have an impact on losses outside the U.S. and it could have an impact on non-U.S. business, where the insured risks are exposed to terrorist attacks in the U.S. Further clarification is being sought on this latter point. The Act does not apply to U.S. reinsurance. Nevertheless, underwriters reinsuring U.S. business should consider how the Act would affect ceding companies.

2. Provisions of the Act

Summary: The Act would establish Federal reinsurance support for commercial property and casualty exposures against an "act of terrorism" (as defined in the Act) in the US. It obliges insurers, including Lloyd's, to make available coverage for terrorism (only for a defined "act of terrorism" under the Act – see item 4 below) and restricts the exclusion of such coverage.

3. Key Implications / Issues for the Lloyd's Market

The U.S. Terrorism Risk Insurance Act would establish a temporary program within the Department of the Treasury, under which the U.S. Federal Government would share the risk of loss from future terrorist attacks with the insurance industry. It would not apply in the event of war[1] and losses of at least $5 million (aggregate losses for any act of terrorism) must be reached before the program will be triggered. The three year program provides 90% Federal reinsurance ("financial assistance") at no cost to non-life direct insurers on a quota share basis above retention points for insured losses resulting from defined "acts of terrorism" which cause damage within the United States - The Act will apply to losses occurring within the U.S. States and territories, U.S. Territorial Sea and U.S. Continental Shelf of the U.S. It will also apply "to an air carrier (as defined in section 40102 of title 49, United States Code), to U.S. flag vessels (or a vessel based principally in the United States, on which U.S. income tax is paid and whose insurance coverage is subject to regulation in the U.S.), regardless of where the loss occurs, or at the premises of any U.S. mission."

The Program covers insurers licensed in one or more states, NAIC/IID white-listed surplus-lines and federally approved MAT insurers – and thus includes Lloyd's syndicates. A per insurer (per syndicate) deductible applies based on direct earned premium in covered lines. For the "Transition Period" between the potential enactment of the Bill and December 31, 2002, a deductible equal to 1% of the value of each participating insurer's 2001 direct earned premiums will apply. This rises in 2003 to 7% of 2002 direct earned premium (Year 1) and in 2004 (Year 2) to 10% of 2003 direct earned premium. If the Program is extended to 2005 (Year 3), the deductible will again rise to 15%. Above the deductible, insured losses are reimbursed by the Federal Program at 90%, up to a combined aggregate Program limit of $100 billion annually. Appendix 1 provides further information on the Program structure. Participation in the Program is mandatory during the first two years.

The Bill has been the subject of widespread debate both in terms of domestic licensed and non-U.S. insurers. Technical amendments / 'corrections' have been made as insurers and other interested parties have highlighted issues / sought clarification. Lloyd's is still awaiting further clarification on some aspects of the Act. The U.S. Treasury Department is to issue implementing regulations that may clarify some issues, though the timing of those regulations is uncertain. A NAIC Model Bulletin discussing implementation issues is also expected next week. The provisions of the Act as they have been defined to date are thus covered here.

[1] Except in respect of coverage for workers compensation.

4. Nullification of Terrorism Exclusions

The Act nullifies Pre-existing Terrorism Exclusions. It states that:

"(a)GENERAL NULLIFICATION.-Any terrorism exclusion in a contract for property and casualty insurance that is in force on the date of enactment of this Act shall be void to the extent that it excludes losses that would otherwise be insured losses."

It is emphasised that the term 'terrorism' relates only to a U.S. "act of terrorism"[2] as certified by the Secretary of the Treasury, in concurrence with the Secretary of State and the Attorney General of the United States, meaning that, exclusion is only void to the extent of provision under the Act. To be certified, damage from the terrorist act must occur within the United States (except in the case of air carriers, vessels or if occurring on the premises of a U.S. mission) and must have been perpetrated on behalf of a foreign person or foreign interest.

All other terrorism exclusions will stand. Overall exclusions (applying to the whole policy, not merely the terrorism peril) e.g. of nuclear or chemical perils, are valid.

For licensed business from Illinois, Kentucky and the USVI, terrorism exclusion clauses approved by the State Insurance Departments shall be void as of the effective date of the Act to the extent that they exclude losses that would otherwise be insured losses under the Federal Program.

Preemption of State Approval
State approval of any terrorism exclusion shall be void to the extent that it excludes losses that would otherwise be insured losses. Because the Act voids state approval of such exclusions, terrorism exclusions may have to be refiled. And, although the Act expressly preempts prior approval of terrorism exclusions, it does not preempt 'file and use' statutes. Thus, in Illinois which has a file and use statute, clarification from the Illinois Department of Insurance will be sought.

5. Mandatory Participation & Action Required by Underwriters & Brokers

Insurers included under the Program must "make available", in respect of all relevant commercial property and casualty policies[3], coverage for insured losses resulting from "acts of terrorism". Such coverage should not "differ materially from the terms, amounts and other coverage limitations" applicable to losses arising from events other than acts of terrorism.

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[2] The Act provides that the limit for aggregated insured losses per calendar year (2003 also includes the transition period) is $100 billion for all "acts of terrorism".

[3] All commercial P & C lines are affected, excepting: Reinsurance, crop, medical malpractice, personal lines, PMI, mono-line financial guaranty, National Flood Insurance Programs and life and health. Marine, aviation and transport business is encompassed under the Act. Coverage will apply to US situs risks / losses arising from "acts of terrorism" in the U.S, except in the case of designated air carriers, vessels and U.S. missions. Further clarification is being sought on whether "all property and casualty insurance policies" is limited to U.S. insureds, or all insureds with U.S. exposures. As we understand it to date it will be limited to U.S. insureds. The benefits of the reinsurance program would, however, in the event of an "act of terrorism" resulting in damage in the US, extend to non U.S. insureds suffering losses in the U.S. as a result of such an "act of terrorism", if they have general coverage with an insurer encompassed in the Program. Further guidance is expected from the U.S. Treasury in the near future.

Insurers must therefore notify the insured, offering coverage for "acts of terrorism". Additional premium may be charged. Having notified the insured, insurers may reinstate exclusions in respect of "acts of terrorism" if:

- The customer authorises the reinstatement of the exclusion in writing; or

- The customer fails to pay any stated additional premium (the insured must be provided with at least 30 days notice of the date on which the terrorism exclusion will be reinstated if no payment is received). Underwriters will be on risk from the date of enactment. Further clarification is being sought in relation to coverage issues during the 30 days between notice being sent to the insured and their response.

Failure to comply with notice conditions could result in penalties to insurers and could jeopardise the benefit of the Federal Reinsurance coverage. Market Supervision will be monitoring this key risk. Managing Agents' systems must record evidence of notification and procedures must be put in place to track responses from insureds. Thereafter, systems and procedures must monitor exposure on an on-going basis.

I. In-Force Policies:

In anticipation of the Bill being enacted, insurers should prepare to notify all relevant existing insureds.

Disclosure and notices must be provided within 90 days of enactment of the Bill. These should provide "clear and conspicuous disclosure" to policyholders of (a) premium charged for insured losses covered by the Program and (b) the "Federal share of compensation" for insured losses under the Program.

Details of the coverage change / exact nature of the coverage provided under the statutory scheme should be provided. The options of coverage (with any additional premium clearly shown) or the fact that, with the insured's written authorisation, the exclusion may be reinstated should be explained. (Again, the insured must be provided with at least 30 days notice of the date on which the terrorism exclusion will be reinstated if no payment is received.) LeBoeuf, Lamb, Greene & MacRae L.L.P., in conjunction with Lloyd's and the LMA have produced a preliminary model notice applicable to policies in force on the date of enactment of this legislation. This is attached as Appendix 2. Further clarification on the parties responsible for / involved in communication – particularly in respect to group programs – and the duties of agents and brokers is being sought.

If the policyholder fails to pay any additional premium within 30 days of notification, the insurer may reinstate the exclusion (at the time of writing, we understand that this can be retroactive to the date of enactment). Underwriters need take no further action if the policyholder does not revert - it being the case that whilst participation in the Program is mandatory, the insurer need only make the coverage available in respect of all relevant commercial property and casualty policies.

II. Proposals / Later-issued Policies:

The disclosure and notification should be provided at the time of offer, purchase and at renewal. This disclosure is required for all policies issued after the date of enactment, but is only required to be made on separate line items for policies issued more than 90 days after enactment.

Whilst policies for which unrestricted terrorism coverage is already in place will not be directly affected when the Act is passed, notification and disclosure will be required at renewal.

Property and casualty insurers will be required to "make available" "acts of terrorism" coverage for subsequent years of the Program and to identify the premium attributable to this protection (again, further clarification on premium formulae is being sought).

Underwriters should take care in notices and in proposals not to imply terrorism coverage beyond that covered under the Act - noting its specific terminology.

There is nothing in the Act that would prevent insurers from cancelling the policy / coverage (subject to normal cancellation requirements). Equally, further coverage can be negotiated for terrorism coverage beyond that provided under the Act - either as part of a policy or on a stand-alone basis.

The Act does not address whether surplus lines insurers may deliver notices directly to policyholders where this might contravene state surplus lines laws that prohibit direct contact with insureds. However, the need to deliver notices quickly may make it advisable for underwriters to deliver notices directly to insureds, but also to deliver a second copy of the notice via a licensed surplus lines broker.

6. Additional Premiums & Premium Income Limits

Additional premium charged for providing "acts of terrorism" coverage on policies already issued may result in the premium income for some syndicates exceeding their underwriting capacity. Lloyd's is currently in discussion with the FSA in respect of premium income ramifications for the market.

7. Surplus Lines Trust Fund Implications

To the extent that insureds opt to pay additional premium for "acts of terrorism" coverage, underwriters increased liability for surplus lines policies will need to be funded in the Surplus Lines Trust Fund. It is unclear if credit will be allowed for the 90% recoverable under the Federal Program. Underwriters should, until clarification is received, give consideration to issues arising from this additional funding.

8. Double Insurance Implications

The Federal reinsurance program will respond before other 'private' coverage[4] if the private reinsurance agreements so provide. The Federal Share of compensation for insured losses under the Program shall be reduced by the amount of compensation provided by the Federal Government to any person under any other Federal Program for those insured losses.

In the instance of 'Stand Alone' terrorism policies, double insurance exposure may exist until the insured fails to pay an additional premium or cancels element of coverage in either policy.

9. Submission of Premium Data to the NAIC

To enable the U.S. Government to determine earned / written premium and thus deductibles and to monitor exposure levels, data reporting is required. This data will need to be submitted to the NAIC, on their behalf. It is likely that underwriters' submissions will need to be supplemented to meet the reporting requirements. Guidelines for reporting to the NAIC are yet to be finalised.

10. Further Information

LeBoeuf, Lamb, Greene & MacRae, L.L.P. made a presentation to Lloyd's on the 7 November 2002, covering the Bill, as then detailed. Detailed slides from the presentation have been circulated by the LMA via their fortnightly publication 'lm@rket'. Members / Lloyd's underwriters can obtain copies of the slides from the LMA, contact: Martin Roberts on Lloyd's extension 8370 (by email at martin.roberts@lloyds.com) or from the Worldwide Markets division in Lloyd's, on extension 6677 (email at market.services@lloyds.com).

A further market bulletin will be issued shortly.

A current version of the enrolled Bill in its entirety can be viewed via http://thomas.loc.gov. It is important that the instructions below are followed to ensure that you are viewing the latest version of the Bill. To get the pdf file of the Bill:

(a) Go to http://thomas.loc.gov

(b) Toward the top of the page, there is a box where you can search for a Bill by its number. Type in "hr3210" (without the quotes), and click 'Search'.

(c) You will be taken to a page where you will need to select which version of the Bill you want. The third item should be the '"Enrolled Bill as Agreed to or Passed by Both House and Senate." Click that link.

(d) The page you will be taken to has a row of 7 boxes near the top, each with a different link to various bill-related information. The box at the extreme left reads: "GPO's PDF version of this bill". Click that link.

(e) Click "Continue." It takes a minute to load, but this will bring you to the Bill.

[4] Coverage under the Federal Program will cover fire following, under losses certified by the Act.

Appendix 1

Structure of the three year Program - Federal Terrorism Risk Insurance Act of 2002

Up to $100 Billion
Annual Aggregate limit of liability for both the Insurance Industry and Federal Government

Federal Terrorism
Risk Insurance Act of 2002
Coverage[5]

Insurer's 10% Quota Share Participation above deductible

Deductible
A defined % of the Insurer's Relevant Direct Earned Premiums in a Given Year

Both the deductible and quota-share exposures in the program may be reinsured by the insurer.

Defined: "act of terrorism":

- Violent or dangerous act
- Damage "within the United States" or to designated U.S flag vessel or air carrier, wherever located, or the premises of a U.S. mission.
- Committed "on behalf of any foreign person or foreign interest" to "coerce" U.S. population or "influence" U.S. policy
- Certified by Treasury … and not subject to judicial review
- Causes at least $5 million in losses
- Not during declared "War" (except for Workers Compensation)

5 In the event of an "act of terrorism" the Act provides for the U.S. Treasury to recoup some of the costs by a surcharge on property & casualty policies, at an annual maximum of 3% of premium charged for such coverage under the policy. (Policy Premium Surcharge on property & casualty insurance policies is on policies in force after the date of the establishment of such a recoupment scheme.)

Appendix 2

Draft Notice. This is in respect of surplus lines business. With minor amendment (by removing reference to surplus lines) it may be used in respect of exempt business.

It should be noted that the Treasury / NAIC may issue guidelines for notices and the notice below may thus be superseded.

REVISED
11/18/02

[NAME OF INSURER] – (CERTAIN UNDERWRITERS AT LLOYD'S)

NOTICE OF COVERAGE OF U.S. ACTS OF TERRORISM AND ADDITIONAL PREMIUM

DATE OF THIS NOTICE: _____________
RE: [Name and address of Policyholder]
[Policy Number or Other Reference]
[Policy Effective Dates:]
[Identification of Covered Property/Exposures]

[Additional Terrorism Risk Premium: $_____]
Surplus Lines Tax @ ____%: $_____]

TOTAL DUE $_____

[Remittance Instructions:] [Retail Broker or Direct to Insurer]
[PAYMENT DATE: {T+30}]

As used in this notice, "we," "us," "our," and "ours" refers to [NAME OF INSURER] and "you," "your" and "yours" refers to insured parties under the captioned insurance policy.

On November __, 2002, the President of the United States signed into law the Terrorism Risk Insurance Act of 2002 (the "Act"). The Act establishes a system of shared public and private compensation for insured losses resulting from certain acts of terrorism for policyholders with commercial property and casualty coverage as described below. This notice informs you of your rights and obligations under the Act.

Expanded Coverage Under the Act

Under the Act, "**insured loss"** (as defined in the Act) previously excluded under your insurance policy by a terrorism exclusion will be covered from the date the Act takes effect (i.e. November __, 2002) until the expiration of your policy if you pay us the additional premium for such coverage by the Payment Date shown in the above box. An "**insured loss**" is any loss covered by "**property and casualty insurance**" that is caused by an "**act of terrorism**" that meets certain other criteria set out in the Act. (The Act's definition of each of these **bolded** terms is summarized below.)

ONLY "INSURED LOSS" AS DEFINED BY THE ACT WILL BE COVERED. COVERAGE UNDER YOUR POLICY FOR LOSSES THAT DO NOT FALL WITHIN THE DEFINITION OF "INSURED LOSS" IS NOT AFFECTED BY THE ACT OR BY THIS NOTICE. THE TERRORISM EXCLUSION IN YOUR POLICY STILL APPLIES FOR LOSSES ARISING FROM ANY ACTS OR EVENTS THAT ARE NOT INCLUDED IN THE ACT'S DEFINITION OF "ACT OF TERRORISM."

THE ACT AND THIS NOTICE ONLY AFFECT THE TERRORISM EXCLUSION IN YOUR POLICY. ALL OTHER TERMS AND CONDITIONS OF YOUR POLICY, INCLUDING APPLICABLE LIMITS AND DEDUCTIBLES, ARE NOT AFFECTED BY THE ACT OR THIS NOTICE AND STILL APPLY TO YOUR COVERAGE UNDER THE POLICY.

Federal Share of Compensation for Insured Loss

Under the Act, the Federal government will reimburse us for 90% of our insured losses in excess of a deductible until total Federal payments to all participating insurers reach $100 billion per annum. Our deductible will be:

- 1% of our 2001 direct earned premium for "insured loss" that occurs during the balance of 2002, and
- 7% of our 2002 direct earned premium for "insured loss" that occurs during 2003.

Other deductibles will apply to insured losses that occur during subsequent years during which the program is in effect.

For purposes of determining such deductibles, "direct earned premium" means only the premiums earned on the commercial lines of property and casualty insurance covered by the Act for U.S. risks or vessels, aircraft and U.S. missions outside the U.S. covered by the Act.

Additional Premiums for Coverage for "Acts of Terrorism"

The new terrorism coverage we are providing pursuant to the Act requires an increase in the premiums assessed on current policies. The additional premium covers the additional loss exposures that we retain under the Act.

Effective immediately, the premium currently assessed on your Policy will be increased to reflect the additional coverage we are providing to you. The amount of the additional premium you must pay is shown in the above box and must be remitted to us in accordance with the instructions shown in the box.

THE TERRORISM EXCLUSION IN YOUR ORIGINAL POLICY WILL BE REINSTATED IF WE DO NOT RECEIVE PAYMENT OF THE ADDITIONAL PREMIUM FROM YOU BY [5:00 P.M., EASTERN STANDARD

TIME] [OUR CLOSE OF BUSINESS] ON THE PAYMENT DATE. THIS REINSTATEMENT OF THE EXCLUSION WILL BE EFFECTIVE NOVEMBER [ ], 2002 AND YOU WILL HAVE NO COVERAGE FOR "ACTS OF TERRORISM."

YOU MAY ALSO WRITE TO US AFFIRMATIVELY AUTHORISING THE REINSTATEMENT OF THE TERRORISM EXCLUSION.

Key Definitions

Key definitions under the Act that affect your coverage are "**insured loss,"** "**act of terrorism**" and **"property and casualty insurance**." Set forth below is a summary of the definitions of these terms. This summary is for information purposes only and shall not be interpreted to enlarge coverage under your policy beyond that specified by the Act.

An "**insured loss**" is any loss covered by "**property and casualty insurance**" that is caused by an "**act of terrorism**" (including an act of war, in the case of workers' compensation) if such loss:

- occurs within the U.S.,
- occurs to an air carrier (as defined in 49 U.S.C. § 40102), to a U.S. flag vessel (or a vessel based principally in the U.S., on which U.S. income tax is paid and whose insurance coverage is subject to regulation in the U.S.), regardless of where the loss occurs.
- occurs at the premises of any U.S. mission.

An **"act of terrorism**" is defined as any act certified by the U.S. Secretary of the Treasury in concurrence with the U.S. Secretary of State and the U.S. Attorney General:

- to be an act of terrorism;
- to be a violent act or an act that is dangerous to human life, property or infrastructure;
- to have resulted in damage within the United States or outside of the United States in the case of U.S. missions and air carriers and vessels described above;
- to have been committed by an individual or individuals acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States government by coercion.

An act cannot be certified as an "act of terrorism" unless total property and casualty insurance losses resulting from the act exceed $5 million. An act committed as part of the course of a war declared by Congress also can not be certified as an "act of terrorism," except with respect to any coverage for workers' compensation.

"**Property and casualty insurance**" means commercial lines of property and casualty insurance, which is defined to include excess insurance, workers' compensation insurance and surety insurance, but does not include:

- Reinsurance
- Personal lines insurance
- Crop or livestock insurance
- Private mortgage insurance as defined in 12 U.S.C. 4901
- Financial guaranty insurance issued by a monoline financial guaranty insurance corporations
- Medical malpractice insurance
- Life and health insurance, including group life insurance
- Flood insurance provided under the National Flood Insurance Act of 1968(42 U.S.C. §§ 4001 et seq.)

cc: Placing Broker [if Notice is provided direct to Insured]