| By Joseph S. Harrington, CPCU |

FINE DISTINCTIONS; STARK CHOICES

Changes in federal terrorism program force carriers and agents to discern when coverage must or cannot be offered

Give credit to officials of the U.S. Department of the Treasury. Charged with administering the federal Terrorism Risk Insurance Program (TRIP), Treasury officials have sought to do so in a manner consistent with how the property/casualty industry categorizes its lines of insurance.

In December 2005, Congress modified TRIP to eliminate federal terrorism reinsurance for commercial auto, commercial crime, farmowners multi-peril, professional liability, and surety insurance—all lines that had been previously covered under the program.[1]

Elimination of those lines gave rise to some questions: How are farm policies other than farmowners treated under TRIP? How are coverages from lines eliminated from TRIP treated when they are built into or endorsed onto policies, such as businessowners or output policies, that are still covered under the program?

The American Association of Insurance Services (AAIS) raised those questions with the Treasury Department in January 2006, and Treasury officials responded with the principle they have invoked since the inception of the program: TRIP coverage follows annual statement categories.

To the extent that a policy's premium is reported under a TRIP-covered line on an insurer's annual statement, that policy will be reinsured under the federal terrorism program, with an exception for professional liability coverage (discussed below).

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For example, consider an AAIS-based Farm Properties policy whose premium is reported entirely on Line 1. Fire is eligible for coverage under TRIP. An AAIS-based Farmowners policy whose premium is reported entirely on Line 3, Farmowners Multi-Peril, is not eligible.

Black and white choice

Insurance marketing is rarely as simple as our example, however. The contrast in treatment of "farm fire" and farmowners policies raises some knotty questions:

- Does everyone involved in a transaction know what kind of policy is being sold, and how its premium is reported? Many "farm" policies are unique, proprietary combinations of different components, some of which may be eligible for federal terrorism reinsurance, some not.
- What happens when coverages reinsured under TRIP are packaged with lines not included in the program? In some cases, the liability component of a farmowners policy will be provided with a general liability form. Depending on how the premium is reported, the liability coverage can be reinsured under TRIP.

These questions might be of only academic interest were it not for a choice immediately facing carriers and agents: If a policy or coverage is eligible for reinsurance under TRIP, applicants *must* be offered the option of purchasing the coverage.

If one fails to offer federal terrorism coverage on a policy that could qualify for it, and a covered attack occurs, then a policyholder or carrier (depending on what exclusions are in place) might be fully exposed to a loss that could have been reinsured.

However, if a policy or coverage is not reinsured under TRIP, and coverage for terrorism is provided in the erroneous belief that it is, a private insurer or reinsurer may be exposed to an unanticipated loss.

This is an either-or decision with potentially a direct impact on an agent's errors and omissions exposure or a carrier's market conduct, depending on how states enforce compliance with the federal program.

Built in or added on

There are other situations where coverages that are reinsured under the federal program are built into or endorsed onto policies that are not otherwise covered, and vice versa.

Staying with farm insurance, what is one to do when equipment breakdown coverage, which can be reinsured under TRIP, is endorsed onto a farmowners policy, which generally cannot? In 2005, AAIS and the Hartford Steam Boiler Inspection & Insurance Company developed equipment breakdown coverages for use with AAIS farm lines.

Here's what AAIS advises in such cases:

- If the premium for equipment breakdown coverage on a farmowners policy is included in the premium reported on Line 3, Farmowners Multi-Peril, loss caused by terrorism can be excluded without offering coverage under the federal backstop.
- If equipment breakdown premium for a policy is reported on Line 27, Boiler & Machinery, or under any other category covered by TRIP, federal terrorism coverage must be offered.

AAIS is providing similar advice to its affiliates regarding commercial crime coverages removed from the federal program:

- If commercial crime coverage is provided on a monoline crime form, the premium would typically be reported on Line 23, Fidelity, or Line 26, Burglary and Theft. Those lines are not covered under TRIP.
- If crime coverage is built into a commercial property policy on an incidental basis, and the crime-related premium is included in the premium reported on, say, Line 5.1, Commercial Multi-Peril (non-liability), then federal terrorism reinsurance, which must be made available for the policy, would apply to the crime coverage as well.

Companies enter a "gray area," however, when they include monoline crime policies in commercial package policies and report the premium for them under Line 5.1, Commercial Multi-Peril (non-liability). AAIS believes that federal reinsurance may be excluded for crime coverages whose premium can be reported separately.

Liability concerns

The pattern of "coverage follows the category" continues with commercial umbrella and excess liability policies—up to a point.

As long as the premium for an umbrella/excess policy is reported under Line 17, Other Liability, or some other covered line, the policy can be reinsured under TRIP. In such cases, federal reinsurance for commercial umbrella/excess policies would extend to exposures that may not otherwise be covered under TRIP, most notably, commercial auto.

(Incidental auto coverages in primary property and liability policies may be reinsured under TRIP as well, depending on how their premium is reported.)

In most cases, carriers and agents should expect to offer federal terrorism insurance to buyers of commercial umbrella/excess policies. As a practical matter, the only exceptions would be if the premium was reported entirely under an auto line, or if the underlying primary policy covered only professional liability exposures.

The treatment of professional liability coverages under TRIP is another complication for carriers and agents.

In the same conference call where they reaffirmed the principle that TRIP coverage would follow along annual statement lines, Treasury officials added the exception that there would be no reinsurance under the program for professional liability coverages, no matter how they are provided or how the premium for them is reported. (To date, there is no annual statement line identified as professional liability insurance.)

This means there is no coverage under TRIP for professional liability exposures picked up by commercial umbrella/excess policies, or for incidental professional liability exposures endorsed onto commercial package policies.

Treasury officials indicated that carriers would be allowed to exclude premium for professional liability exposures from calculations to determine direct earned premium and deductibles under TRIP.

Who's responsible?

Changes in the federal terrorism reinsurance program have not created much concern among agents so far, says Bill Wilson, director of the "Virtual University" maintained by the Independent Insurance Agents and Brokers of America (IIABA).

In contrast to being "swamped" with questions after TRIP was first enacted in 2002, Wilson said in February that he had yet to hear a single question about the program's extension in 2005.

Pat Borowski is concerned, however.

The senior vice president of the National Association of Professional Insurance Agents (PIA National) says agents should insist that carriers provide statements in writing clarifying how policies are constructed, how the premium is reported, and in what cases TRIP coverage must or must not be offered.

The duty to clarify "make available" obligations lies with carriers, Borowski says, but agents should establish that duty clearly to protect themselves.

For organizations like AAIS, providing advice on a federal program is a departure.

Advisory organizations are being asked to determine how the logic of Treasury Department policy applies to the situations encountered by their member companies, much as they are frequently called upon to do regarding state-level mandates.

But, in determining how state directives apply to their members, advisory organizations have many practices and precedents to draw upon. In the case of federal terrorism reinsurance, not only is the policy emerging, but so is the manner in which the policy is made.

Fortunately, there has not been another major event since the September 11 attacks to create a precedent.

Hopefully, there won't be.

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[1] Federal terrorism reinsurance under TRIP is still restricted to "certified" acts of terrorism. That is, coverage under the program is triggered only when designated federal officials certify that damages or casualties from an act or series of acts surpass specified levels of damages or casualties, and that the act or acts were inspired, directed, or carried out by foreigners or foreign interests.