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CRE Reading Program Questions

All quizzes MUST be taken online.

Multiple Choice/True or False Questions — Submit Answers Online

The Relevance of the McCarran-Ferguson Act

1. Is congressional delegation of authority to the states a permanent delegation of authority
   a. True
   b. False
2. Every person engaged in the business of insurance is subject to the laws of the states that they operate in
   a. True
   b. False
3. Justice Robert Jackson of the Supreme Court was not in favor of having Insurance regulated by the Federal Government
   a. True
   b. False
4. United States V. South Western Underwriters case overturned a long-held belief insurance was not interstate commerce
   a. True
   b. False
5. The Virginia Supreme Court in Paul v. Virginia determined that insurance was not considered to be interstate commerce subject to jurisdiction by Congress
   a. True
   b. False

Study of Small Insurer Competitiveness in the Terrorism Risk Insurance Marketplace

1. The first study to identify competitive challenges to small insurers is to be conducted in 2019
   a. True
   b. False
2. TRIA requires the studies of small insurers to include analyses of the availability and cost of private reinsurance for small insurers
   a. True
   b. False

3. Reinsurance is considered to be an eligible line under TRIP.
    a. True
    b. False
4. Under TRIP, once an insurer meets its insurer deductible and the Program Trigger is satisfied, the federal government will pay only a certain percentage of that insurer's losses.
    a. True
    b. False

Informed Decisions on Catastrophe Risk - Post Flood Mitigation - The NFIP's Increased Cost of Compliance Coverage

1. Increased Cost of Compliance (ICC) coverage can be utilized by homeowners to bring their flood-damaged homes into compliance with current floodplain management regulations when the following conditions are met:
    a. A policyholder's home has been substantially damaged (more than 50%) after a flood event.
    b. A federal state of emergency was issued for their local area.
    c. All of the above
    d. None of the above
2. Homeowners with NFIP coverage are required to upgrade their flood-damaged home to meet current regulations. Upgrades can take the form of ______.
    a. Elevating the home
    b. Undertaking flood-proofing activities
    c. Relocating
    d. All the above
3. Which of the following statements about National Flood Insurance Program coverage is true?
    a. NFIP Policyholders automatically receive ICC coverage in new and renewed policies since 1997.
    b. NFIP Policyholders may receive up to $30,000 for ICC claims to implement flood mitigation measures.
    c. NFIP Policyholders are limited to a combined payout of $250,000 from their standard flood policy and NFIP ICC coverage.
    d. All of the above

4. Premium rates for ICC coverage is based upon all of the following factors, except for ____:
    a. The desired building coverage dollar amount.
    b. The likelihood of a hurricane impacting the area.
    c. The elevation difference between the lowest floor and the floodplain zone (BFE).
    d. The building's status as a pre-Flood Insurance Rate Map structure.
5. As of August 2017, there were four proposals to reform the National Flood Insurance Program. All of these proposals provide for _____.
    a. Increasing primary coverage for ICC claims to above $30,000.
    b. Decreasing the NFIP payout cap on residential building coverage limits.
    c. Improving standardized communication to homeowners regarding the NFIP coverage limits.
    d. Including costs of ramps or elevators as eligible activities when elevating homes for homeowners with disabilities.

Micro-captive arrangement deemed not to be insurance; taxpayer loses in Avrahami case

1. In determining the legitimacy of an insurance company, and thereby qualify to deduct insurance premiums, the U.S. Tax courts look for the following characteristic(s):
    a. Involve risk-shifting
    b. Involve risk-distribution
    c. Involve insurance risk
    d. Meet commonly accepted notions of insurance
    e. All of the above
2. Another(Other) factor(s) the U.S. Tax courts consider (to determine premium deductibility) include:
    a. Is the company organized, operated, and regulated as an insurance company?
    b. Is the insurer adequately capitalized?
    c. Are policies valid and binding, and claims paid?
    d. Are premiums reasonable and the result of an arm's length transaction?
    e. All of the above

3. Generally, a micro-captive should operate as a separate risk-bearing enterprise and function no differently than a third-party insurer.
    a. True
    b. False
4. Fronting companies are required to have a valid business purpose, operate as an insurance company, and is not formed merely as a mechanism to meet risk-distribution requirements.
    a. True
    b. False
5. An insurance company is generally considered to be a small insurance company when premiums are less than $1.2 million (note this limitation has been increased to $2.2 million starting in 2017 to adjust for inflation).
    a. True
    b. False

The Relevance of the McCarran-Ferguson Act

By Eric Nordman[1], Director of Regulatory Services and CIPR

◆ Introduction

It was 1945 when the 79th U.S. Congress enacted the McCarran-Ferguson Act.[2] The Act was needed to address the outcome of a 1944 U.S. Supreme Court ruling in *United States v. South-Eastern Underwriters Association*.[3] The *South-Eastern Underwriters* decision overturned the long-held belief insurance was not interstate commerce. The decision created confusion in the insurance markets as suddenly the U.S. government found itself in the business of regulating insurance under the Commerce Clause. However, there were no federal laws or a viable regulatory framework to regulate the solvency or market activity of insurers and insurance producers.

The McCarran-Ferguson Act is as relevant today as it was when it was adopted. It is brilliant in its simplicity. It solved a problem created by a significant court case and demonstrated the flexibility of our democracy.

◆ Historical Perspective

Our journey begins with a story about an insurance agent named Samuel Paul. Mr. Paul was a resident of the commonwealth of Virginia. Mr. Paul was appointed by several New York-based fire insurers to represent them as an agent to sell fire insurance policies to Virginia residents. For that to happen, there were several preconditions. The commonwealth had enacted laws requiring insurers and persons representing insurers to obtain a license and post a bond ranging from $30,000 to $50,000 before transacting the business of insurance. Mr. Paul partially complied with the laws of the Commonwealth. He provided the auditor of public accounts with proof of his authorization from the New York insurers to serve as their agent. He submitted an application to the proper office to receive a license. He met several other requirements, including agreeing to pay any taxes due. He balked at providing the required bond. Neither Mr. Paul nor the New York insurers posted the required bond. Mr. Paul's request for a license was denied by the commonwealth based on his refusal to post the required bond.

Despite his unlicensed status, Mr. Paul sold a fire insurance policy to a Virginia resident. Mr. Paul was indicted and convicted for his violation by the city of Petersburg, Virginia. His sentence was a fine of $50. He appealed the decision and his appeal was eventually heard by the Supreme Court and became a landmark case establishing the regulatory framework for insurers from November 1869 until it was overturned in 1944.

In the case *Paul v. Virginia*, at issue was Article IV, Section 2 of the U.S. Constitution.[4] The pertinent sentence at issue was, "The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several states." Mr. Paul claimed the Virginia law requiring he be licensed and post bond infringed on his privileges granted under the Constitution.

Justice Stephen Johnson Field, an appointee of President Abraham Lincoln, wrote the majority opinion of the court. In it he said, "corporations are not citizens within its meaning. The term citizens as there used applies only to natural persons . . . not to artificial persons created by the legislature, and possessing only the attributes which the legislature has prescribed."[5] He went on to say, "Special privileges enjoyed by citizens in their own States are not secured in other States by this provision. It was not intended by the provision to give to the laws of one State any operation in other states. They can have no such operation, except by the permission, express or implied, of those States. The special privileges which they confer must, therefore, be enjoyed at home, unless the assent of other States to their enjoyment therein be given."[6]

Thus, the conclusion when the Supreme Court ruling affirmed the decision of the Supreme Court of Appeals in Virginia was that insurance was not considered to be interstate commerce subject to jurisdiction by Congress. The court found that insurance policies should be treated as any other contract subject to state law. Therefore, the states were free to regulate and tax the business of insurance as they saw fit.

◆ Concern About Antitrust Activities

Over time, a cartel system evolved for property and casualty insurers where, what we would call today, rating organizations developed. There were a number of these rating organizations and often the by-laws of these organizations required members to adhere to a common set of rates and common policy forms. These requirements were viewed by many as anti-competitive. Significant control was vested

(Continued on page 14)

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[1] The purpose of this article is to provide a historical perspective on the McCarran-Ferguson Act and to explore its relevance today. The opinions expressed in this article are solely my own. They are not the opinions of the National Association of Insurance Commission (NAIC) members individually or collectively or opinions shared by other NAIC staff. This article is being drafted as part of the charge of the NAIC Center for Policy and Research (CIPR) to serve as a thought leader and provide information for public policymakers to consider.

[2] 15 U.S.C. §§ 1011-1015.

[3] *United States v. S.-E. Underwriters Ass'n*, 322 U.S. 533 (1944).

[4] *Paul v. State of Virginia*, 75 U.S. 168 (1868).

[5] Id. at 177.

[6] Id. at 180 181.

with the rating organizations and some of them were ruthless in enforcing their power to the detriment of non-member competitors.

A different scenario developed for life insurers. In the life insurance sector, there were many interlocking directorships, where a buddy system rewarded participants and punished outsiders.

President Franklin D. Roosevelt played a role in the journey. He was interested in fostering competition and was using the National Industrial Recovery Act of 1933 as the tool of choice.[7] That was until it was declared unconstitutional. The National Industrial Recovery Act was part of the legislation designed to help the country recover from the Great Depression. It suspended antitrust laws in favor of an alliance of industries, where businesses were asked to form alliances to write codes of fair competition. Essentially, this was a form of self-regulation. The law created the National Recovery Administration to promote compliance with the self-regulatory guidance, among other things. The National Industrial Recovery Act was declared unconstitutional in May 1935 in the case *A.L.A. Schechter Poultry Corp. v. United States*.[8] At issue was the unlawful assignment of legislative powers to the National Recovery Administration when the Constitution reserved those powers for Congress.

Since the National Industrial Recovery Act could no longer be used to foster competition, the Roosevelt administration turned to the antitrust laws as a way to break up detrimental concentrations of economic power. Ironically the U.S. Department of Justice Antitrust Division looked into a case with ties to Kansas City, MO, the current home of the NAIC. The infamous former Kansas City Mayor Thomas J. Pendergast was under investigation for tax evasion. One element investigated was his failure to report a bribe he received on his income taxes. The bribe originated from a lawyer named Charles Street who represented a Chicago-based fire insurance rating organization. Long story short, Mr. Pendergast shared the bribe with R. Emmet O'Malley, who was, through Pendergast's influence, appointed as superintendent of insurance for Missouri. Discovery during the Pendergast – O'Malley investigation revealed certain anticompetitive behavior by the South-Eastern Underwriters Association, which is covered in the next section.

◆ United States v. South Eastern Underwriters

It was June 5, 1944, when the U.S. Supreme Court delivered an opinion in the *United States v. South-Eastern Underwriters Association* case.[9] The opinion set the insurance world on its heels. The Supreme Court overturned a long-held belief insurance was not interstate commerce and, therefore, not subject to federal anti-trust laws and oversight by the Federal Trade Commission.[10] There was concern a shift from the cartel pricing mechanisms in place at the time would lead to unrestrained competition and many insurer insolvencies.

The South-Eastern Underwriters Association consisted of roughly 200 private stock fire insurers and 27 individuals. In today's parlance, South-Eastern Underwriters would be known as a rating organization. South-Eastern Underwriters was appealing a decision in the district court alleging violations of the federal Sherman Antitrust Act. Specifically, South-Eastern Underwriters was alleged to be part of a conspiracy to restrain interstate trade and commerce by engaging in price fixing and conspiring to monopolize fire and allied lines insurance transactions in several states. Facts presented show South-Eastern Underwriters members controlled 90% of the market in six states (Alabama, Florida, Georgia, North Carolina, South Carolina and Virginia). Among the practices identified were fixing of premium rates and agent commissions; boycotts and other types of coercion and intimidation to force others to join South-Eastern Underwriters; compelling people who needed insurance to buy from South-Eastern Underwriters member insurers; denying reinsurance to non-member insurers; disparaging non-member competitors' services and facilities; and removing appointments for agents who also agreed to work with a non-member insurer.[11]

The Supreme Court majority opinion was written by Justice Hugo Lafayette Black, an appointee of President Franklin D. Roosevelt. In it, Justice Black presents two questions for the court to consider: "Was the Sherman Act intended to prohibit conduct of fire insurance companies which restrains or monopolizes the interstate fire insurance trade?" and, if so, "Do fire insurance transactions which stretch across state lines constitute 'Commerce among the several States' so as to make them subject to regulation by Congress under the Commerce Clause?"[12] The Court assumed an affirmative answer to the first question and focused its analysis on the second question.

Generally, courts do not construe words to have a more narrow meaning than they have in common language. Justice Black noted that to interpret the word "commerce" so

(Continued on page 15)

[7] National Industrial Recovery Act, Pub. L. No. 73-67 § 1, 48 Stat. 195 (1933), *Title I invalidated* by Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935) (Title II expired in June, 1935).
[8] A.*L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935).
[9] *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944).
[10] *Id.* at 571.
[11] Id. at 535-36 (pages 4 & 5).
[12] Id. at 538-39.

as not to include the business of insurance would be giving the word a more narrow definition than in the common language. He found the language of the time to be clear and suggested the meaning of the word "commerce" had not changed since the *Paul v. Virginia* decision. He noted the business of insurance employed more than 500,000 people and its annual premium receipts of $6 billion exceeded the annual revenue receipts of the federal government at the time. He suggested the insurance business touches the home, family, occupation or business of almost every person in the country, often involving more than one state.[13]

He noted that the Commerce Clause must be read broadly so that Congress can "discharge its Constitutional duty to govern commerce among the states.[14]" Furthermore, he found no evidence supporting the notion that the Sherman Act was intended to exclude the business of insurance from its reach. Finally, he determined that the Sherman Act did not necessarily invalidate state laws regulating insurance because few states would allow companies to fix rates and no state would allow the type of destructive business practices alleged in this case.

The Supreme Court was not unanimous in its decision. Writing one of the dissenting opinions was Justice Robert Jackson, another appointee of President Franklin D. Roosevelt. Justice Jackson suggested the majority was not taking a common sense approach to the problem. He said the court was not evaluating the constitutionality of a law enacted by Congress, but rather using a law to strike down the constitutional basis for state insurance regulation.[15] He noted the states had successfully been regulating insurance for more than 100 years. He observed insurance departments have accumulated the institutional experience and wisdom indispensable to good administration.

Justice Jackson noted there was no indication from Congress that it concurs with a plan to federalize insurance regulation and suggested there was evidence to the contrary. He suggested if Congress intended to assume the regulation of the insurance business, it surely would not have relied solely on the anti-trust laws to accomplish the task. He listed several failed bills to establish federal regulation of insurance over a period from 1866 to 1933. He noted that proponents of a federal regulatory system tended to be representatives of the largest insurers. In addition, he pointed out the failure of several federal agencies to effectively regulate other businesses. Specifically mentioned were the Interstate Commerce Commission's failure to deal with railroad abuses, the Beef Trust and the Oil Trust. He noted amicus curiae briefs were received from 35 states protesting the court's decision.[16]

◆ REACTION TO THE SOUTH-EASTERN UNDERWRITERS DECISION

NAIC President Charles F. J. Harrington (Mass.) opened the 75th Annual Meeting of the NAIC on June 15, 1944, at the Edgewater Beach Hotel in Chicago, IL. In his opening remarks he quoted Chief Justice Harlan F. Stone:

> But the immediate and practical effect of the decision now rendered is to withdraw from the states, in large measure, the regulation of insurance and to confer it on the national government, which has adopted no legislative policy and evolved no scheme of regulation with respect to the business of insurance. Congress having taken no action, the present decision substitutes, for the varied and detailed state regulation developed over a period of years, the limited aim and indefinite command of the Sherman Act for the suppression of restraints on competition in the marketing of goods and services in or affecting interstate commerce, to be applied by the courts to the insurance business as best they may.[17]

During the NAIC national meeting, a resolution was adopted unanimously urging the continuation of state regulation of the business of insurance, stating that "the interests of the insuring public can best be served by proper supervision on the part of State Governments, and in keeping with constitutional limitations as defined by the United States Supreme Court over the past seventy-five years."[18] The insurance regulators were galvanized in support of the continuation of state insurance regulation. They were also concerned, without a resolution, insurers would begin to withhold premium tax payments to the states.

Other forces were in play. Writings at the time reveal the development of three separate schools of thought. Each was based on the self-interest of the parties subject to regulation. The result was the development of three separate bills. The fire insurers liked the cartel system which was essentially a form of self-regulation. They were supportive of the Bailey-Walters bill. This bill began in the U.S. House of Representatives and reported out of the U.S. Senate Committee on the Judiciary. It never reached the floor of the Senate.[19]

(Continued on page 16)

[13] Id. at 540-41.
[14] Id. At 551.
[15] Id. at 565.
[16] Id. at 589-94.
[17] 1944 NAIC Proc. 75th Sess. p. 98-99.
[18] Id. at 43.
[19] Kevin P. Hennosy, Fear and Loathing in Insurance Regulation, 157 Pub. Rough Notes., no. 11, Nov. 2014, at 76, 78 (2014).

The McCarran-Ferguson Act as initially drafted, fit the interests of the large stock life insurers. They were anxious to maintain their cozy nature with interlocking boards and exclusion of outsiders. In its initial form the bill provided insurers with a temporary exemption from antitrust law and a permanent exemption from enforcement activity by the Federal Trade Commission. The bill sponsors were U.S. Senator Patrick Anthony McCarran (D-NV) and U.S. Senator Homer Samuel Ferguson (R-MI). They were chair and ranking member of the Senate Judiciary Committee, respectively.[20]

The third bill was known as the "commissioners" bill.[21] It was supported by the independent insurers and independent agents. Support came from the National Association of Insurance Agents and a group of independent insurers.[22] Supporters of this approach worked with U.S. Senator Joseph C. O'Mahoney (D-WY). The first section of the bill provided jurisdiction to the states and allowed the states to regulate and tax the business of insurance. It further stated that federal law could not invalidate, impair or supersede state insurance law. Other provisions exempted insurance from oversight by the Federal Trade Commission and the Robinson-Patman Act. It included a limited exemption from the Sherman Act and the Clayton Act.[23]

◆ The McCarran-Ferguson Act

Senator O'Mahoney was well connected to the Roosevelt administration and he led the effort to bring the three factions together. As a result, Senate Bill 340 of 1945 was proposed as a substitute for the original bill drafted by Senator McCarran and Senator Ferguson. Ironically, even though the bill still carried his name, Senator McCarran did not support it. He instead favored a total and permanent antitrust exemption for the insurance sector.[24]

The new McCarran-Ferguson Act contained most of the text of the "commissioners" bill. There were two significant changes to it. A provision was added to the boycott provision so that it would cover agreements in addition to acts of boycott, coercion or intimidation. The other change was to delete a provision in the "commissioners" bill allowing the states to keep or enact laws in conflict with the Sherman Act or the Clayton Act. The Senate passed the bill as amended and the House passed the "commissioners" bill. The difference between the two was the Senate amendments.[25]

A conference committee was appointed to discuss and iron out the differences. Key players in the discussion were Senator O'Mahoney (D-WY), Senator Orrice Abram "Abe" Murdock, Jr. (D-UT) and Senator Robert Alphonso Taft (R-OH). The House agreed to the new version without debate on Feb. 23, 1945. The Senate debated the report on Feb. 26 and Feb. 27, 1945. The Senate adopted the bill on Feb. 27, 1945. On March 9, 1945, the conference report version of the law was signed by President Roosevelt and became Public Law 15 of 1945.[26]

The complete text of the enacted McCarren-Ferguson Act is included in the appendix of this article. The key provisions of the Act are as follows:

- Congress declares the continued regulation and taxation by the states of the business of insurance is in the public interest (15 U.S.C. § 1011).
- Silence by Congress shall not be construed to impose any barrier to regulation or taxation of the business of insurance by the states (15 U.S.C. § 1011).
- The business of insurance is subject to the laws of the states which relate to the regulation or taxation of the business of insurance (15 U.S.C. § 1012(a)).
- Every person engaged in the business of insurance is subject to the laws of the states which relate to the regulation or taxation of the business of insurance (15 U.S.C. § 1012(a)).
- No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance unless such Act specifically relates to the business of insurance (15 U.S.C. § 1012(b)). This says Congress must specifically mention the business of insurance if it intends a particular piece of legislation to apply to the business of insurance.
- No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance (15 U.S.C. § 1012(b)).

(Continued on page 17)

[20] *Id.*
[21] The complete text of the "Commissioners" bill is included in the appendix of this article.
[22] *Id.* at 86. The National Association of Insurance Agents is now known as the Independent Insurance Agents & Brokers of America, Inc. The group of independent insurers later formed the National Association of Independent Insurers. The National Association of Independent Insurers and the Alliance of American Insurers merged to form the Property Casualty Insurers Association of America (PCI).
[23] Kevin P. Hennosy, *The Moratorium*, 158 Pub. Rough Notes., no. 1, Jan. 2015, at 48, 79 (2015).
[24] *Id.*
[25] *Id.*
[26] Kevin P. Hennosy, *Use It or Lose It*, 158 Pub. Rough Notes., no. 2, Feb. 2015, at 70, 72. The complete text of the adopted McCarran-Ferguson Act is included in the appendix of this article.

- However, the Sherman Act, the Clayton Act and the Federal Trade Commission Act apply to the business of insurance to the extent the business of insurance is not regulated by state law (15 U.S.C. § 1012(b)). This provision requires active regulation by states of the business of insurance to avoid application of the federal antitrust laws to the business of insurance.
- The Sherman Act applies to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation (15 U.S.C. § 1013(b)). Insurers and persons engaged in the business of insurance remain subject to the Sherman Act. The Sherman Act is an antitrust law intended to prevent monopolies or cartels and encourage competitive markets.
- Insurers remain subject to the National Labor Relations Act, the Fair Labor Standards Act and the Merchant Marine Act (15 U.S.C. § 1014).

◆ THE PERIOD FOLLOWING THE ENACTMENT OF THE MCCARRAN-FERGUSON ACT

The enactment of the McCarran-Ferguson Act set off a flurry of activity at the NAIC and in the states. Regulatory frameworks were strengthened and model legislation was discussed and adopted. In a Report of the Subcommittee on Federal Legislation, rate regulation was discussed.[27] Because the cartel approach had clearly been discarded with the enactment of the McCarran-Ferguson Act, the states recognized a pressing need to enact laws to regulate rates used by property and casualty insurers. This led to the development of the Fire and Marine Rating Bill and the Casualty and Surety Rating Bill.[28] These model laws introduced the frameworks for the rating laws in place today. They included several concepts including the formation, licensing and regulation of rating organizations (the advisory organizations of today); the rate standards that rates should not be excessive, inadequate, nor unfairly discriminatory; and the requirements for filing and approval of rates and rating systems. Also included was a prohibition against giving rebates.[29]

It is beyond the scope of this article to go into detail on all the meetings and deliberations of the mechanism establish to assemble all the parts needed to effectively implement the authority granted by the McCarran-Ferguson Act. Persons interested in reading further on the aftermath should look at the information on the All- Industry Committee established in 1946 and documented in the NAIC *Proceedings*, Seventy-Seventh Session 1946.

◆ RELEVANCE OF THE MCCARRAN-FERGUSON ACT TODAY

The McCarran-Ferguson Act is as relevant today as it was when it was first enacted. It contains the basic delegation of authority from Congress to the states with respect to the regulation and taxation of the business of insurance. It has been affirmed as the law of the land in the Gramm-Leach-Bliley Act and in the Dodd-Frank Act.[30]

In today's world, there is much discussion of deregulation and making things easier for businesses. Designing the appropriate amount of regulation of the business of insurance to ensure solvency, promote competitive markets and ensure sound consumer protection can be challenging. It is important for the insurance industry, consumers, insurance producers and regulators to remember deregulation of the business of insurance is not like deregulation of other sectors of American businesses. The congressional delegation of authority to the states is a contingent delegation of authority.

There are two contingencies affecting the delegation of authority. First, Congress can enact legislation applicable to the business of insurance by mentioning it in a bill and affirmatively stating that the legislation applies to the business of insurance. Second, when the states do not enact or maintain laws to regulate the business of insurance, such regulation is left to Congress under the Sherman Act, the Clayton Act and the Federal Trade Commission Act.

Thus, deregulation of aspects of the business of insurance may be accompanied by some unanticipated outcomes with respect to antitrust laws. For example, sharing loss data among competitors as is done through advisory organizations would be considered an antitrust violation. Organizations such as Insurance Services Office and the National Council on Compensation Insurance can only exist under active state regulation of the products they produce and the information they collect.

In addition, if state insurance regulators fail to regulate, the insurance industry does not become deregulated; it merely finds itself with a new master, the Federal Trade Commis-

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[27] 1945 NAIC Proc. 76th Sess. p. 170-171.
[28] Herbert H. Naujoks, *Eight Years After S.E.U.A. – Present Status of the Regulation of Insurance as Commerce*, 35 Marq. L. Rev. 339, 351 (1952).
[29] *Id.*
[30] The Gramm-Leach Bliley Act is formally known as the Financial Services Modernization Act, 15 U.S.C. §§ 6801–6809 (1999). Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

sion. This is an outcome no one expects or thinks about. It is important for all not to forget how relevant the McCarran-Ferguson Act remains today.

◆ Conclusion

It is important for state insurance regulators, as well as regulated individuals and entities, to be familiar with and understand the importance of the McCarran-Ferguson Act. Key concepts in the law provides a contingent delegation of authority to the states to regulate and tax the business of insurance. The contingency is the states must actively regulate the business of insurance or its regulation will return to the federal government under the Commerce Clause of the U.S. Constitution. Insurance is a form of interstate commerce. If there is a regulatory void, federal authorities may fill the void employing the provisions of the Sherman Act, the Clayton Act, and/or the Federal Trade Commission Act.

ABOUT THE AUTHOR

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APPENDIX

LEGISLATIVE PROPOSAL
Submitted to
The Congress of the United States
By
The Executive Committee of the National Association
of Insurance Commissioners
November 1944

TEXT OF LEGISLATION
Recommended by National Association of Insurance Commissioners

Section 1.
That Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation of such business by the several States.

Section 2.
a) The business of insurance, and every person engaged therein, shall be subject to the laws of the respective States which relate to the regulation of such business and which impose fees or taxes thereon.
b) No Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically so provides.

Section 3.
Nothing contained in the Federal Trade Commission Act, as amended, or the Act of June 19, 1936, known as the Robinson-Patman Anti-Discrimination Act, shall apply to the business of insurance or to acts in the conduct of that business.

Section 4.
a) Until July 1, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, shall not apply to the business of insurance, or to acts in the conduct of such business.
b) On or after July 1, 1948, the said Sherman Act shall not apply (1) to any agreement or concerted or cooperative action which prescribes the use of rates for insurance, insurance policy or bond forms or underwriting rules or plans if such rates, forms, rules or plans are required, by the law of the State in which they are to be used, either to be approved by the supervisory official or agency of such State having authority with respect thereto, or to be filed subject to disapproval by such official or agency; (2) to the use of any such rates, forms, rules or plans which have been so approved or filed; (3) to any cooperative or joint service, adjustment, investigation, or inspection agreement relating to insurance, or to acts under such agreement; (4) to any agreement or concerted or cooperative action among two or more insurers to insure, reinsure or otherwise apportion risks taken by the parties to such agreement or any of them, or to issue policies or bonds with joint or several liability; (5) to any agreement or concerted or cooperative action with respect to the payment of insurance agents' or brokers' commissions; (6) to any agreement or concerted or cooperative action with respect to the collection and use of statistics or with respect to policy or bond forms; or (7) to any agreement or concerted or cooperative action providing for the cooperative making of insurance rates, rules, or plans, if such arrangement does not require the use of such rates, rules or plans.
c) Nothing contained in this section shall render the said Sherman Act inapplicable to any act of boycott, coercion or intimidation.

Section 5.
Nothing contained in this Act shall be construed to affect in any manner the application to the business of insurance of the National Labor Relations Act, as amended, or the Fair Labor Standards Act of 1938, as amended.

(Continued on page 20)

Section 6.
As used in this Act, the term “State” includes the several states, Alaska, Hawaii, Puerto Rico and the District of Columbia.

Section 7.
If any provision of this Act, or the application of such provision to any person or circumstances, shall be held invalid, the remainder of eh Act, and the application of such provision to persons or circumstances other than those as to which it is held invalid, shall not be affected thereby.

COMPLETE TEXT OF THE McCARRAN-FERGUSON ACT

15 U.S. Code § 1011 - Declaration of policy
Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.

15 U.S. Code § 1012 - Regulation by State law; Federal law relating specifically to insurance; applicability of certain Federal laws after June 30, 1948

(a) State regulation
The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

(b) Federal regulation
No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: Provided, That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended [15 U.S.C. 41 et seq.], shall be applicable to the business of insurance to the extent that such business is not regulated by State Law.

15 U.S. Code § 1013 - Suspension until June 30, 1948, of application of certain Federal laws; Sherman Act applicable to agreements to, or acts of, boycott, coercion, or intimidation

(a) Until June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act [15 U.S.C. 41 et seq.], and the Act of June 19, 1936, known as the Robinson-Patman Anti-Discrimination Act, shall not apply to the business of insurance or to acts in the conduct thereof.

(b) Nothing contained in this chapter shall render the said Sherman Act inapplicable to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation.

15 U.S. Code § 1014 - Effect on other laws

Nothing contained in this chapter shall be construed to affect in any manner the application to the business of insurance of the Act of July 5, 1935, as amended, known as the National Labor Relations Act [29 U.S.C. 151 et seq.], or the Act of June 25, 1938, as amended, known as the Fair Labor Standards Act of 1938 [29 U.S.C. 201 et seq.], or the Act of June 5, 1920, known as the Merchant Marine Act, 1920.

15 U.S. Code § 1015 - “State” defined

As used in this chapter, the term “State” includes the several States, Alaska, Hawaii, Puerto Rico, Guam, and the District of Columbia.

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Study of Small Insurer Competitiveness in the Terrorism Risk Insurance Marketplace

FEDERAL INSURANCE OFFICE, U.S. DEPARTMENT OF THE TREASURY

JUNE 2017

THE TREASURY DEPARTMENT

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Glossary

Term		Definition
2015 Reauthorization Act	....	Terrorism Risk Insurance Program Reauthorization Act of 2015, Pub. L. 114-1, 129 Stat. 3
2016 Effectiveness Report	....	"Report on the Overall Effectiveness of the Terrorism Risk Insurance Program," U.S. Department of Treasury (June 2016)
CMP	....	Commercial Multi-Peril
DEP	....	Direct Earned Premium
FIO	....	Federal Insurance Office
NBCR	....	Nuclear, Biological, Chemical, or Radiological
P/C	....	Commercial Property and Casualty
Program (or TRIP)	....	Terrorism Risk Insurance Program
Program Cap	....	Annual exposure limit for the federal government and insurers under the Program
Program Trigger	....	Minimum amount of aggregate industry insured losses resulting from an act of terrorism that must occur in a calendar year before any federal payments are made
Study	....	This "Study of Small Insurer Competitiveness in the Terrorism Risk Insurance Marketplace," U.S. Department of Treasury (June 2017)
Secretary	....	Secretary of the Treasury
September 11 Attacks	....	Terrorist attacks occurring on September 11, 2001
Small Insurer	....	An insurer as defined under 31 C.F.R. § 50.4(z)
SNL Financial	....	SNL Financial, LC
Treasury	....	U.S. Department of the Treasury
TRIA	....	Terrorism Risk Insurance Act of 2002, as amended
TRIP (or Program)	....	Terrorism Risk Insurance Program
TRIP-Eligible Lines of Insurance	....	Commercial property and casualty insurance subject to the Terrorism Risk Insurance Program pursuant to 31 C.F.R. § 50.4(w)

I. Introduction

Prior to September 11, 2001, commercial property and casualty (P/C) insurance policies generally did not exclude coverage for losses resulting from terrorism. The events of September 11, 2001 (September 11 Attacks) resulted in approximately $43 billion of P/C insurance losses,[1] more than two-thirds of which were reimbursed by reinsurers to insurers.[2] Thereafter, insurers and reinsurers began to exclude coverage for terrorism risk from P/C policies.

Congress enacted the Terrorism Risk Insurance Act of 2002 (TRIA),[3] in part, because the widespread unavailability of terrorism risk insurance "could seriously hamper ongoing and planned construction, property acquisition, and other business projects, generate a dramatic increase in rents, and otherwise suppress economic activity."[4] TRIA established the Terrorism Risk Insurance Program (TRIP or Program), which requires insurers to make terrorism risk coverage available within certain lines of commercial P/C insurance (TRIP-eligible lines of insurance).[5] To assist insurers with the potential financial exposure resulting from this required offer of terrorism coverage, certain insurance losses resulting from an "act of terrorism" as defined by TRIA are eligible for reimbursement through the Program.[6] The Program is administered in the U.S. Department of the Treasury (Treasury) by the Secretary of the Treasury (Secretary) with the assistance of the Federal Insurance Office.[7]

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[1] Insured losses shown in 2015 dollars. *See* Jayleen R. Heft, "9/11 attacks 15 years later: A look at losses by the numbers," PropertyCasualty360 (September 7, 2016), *available at* http://www.propertycasualty360.com/2016/09/07/9-11-attacks-15-years-later-a-look-at-losses-by-th.

[2] "9/11 and Insurance: The Eight Year Anniversary," Insurance Journal (September 11, 2009), *available at* http://www.insurancejournal.com/news/national/2009/09/11/103694.htm.

[3] 15 U.S.C. § 6701 note. The provisions of TRIA, as amended (including the Terrorism Risk Insurance Program Reauthorization Act of 2015, Pub. L. 114-1, 129 Stat. 3), appear in a note of the United States Code, and, therefore, references to the provisions of TRIA or the 2015 Reauthorization Act are identified by the sections of the law (*e.g.*, "TRIA § 102(1) (definition of an "act of terrorism")").

[4] TRIA § 101(a)(5).

[5] *See* TRIA § 103(c). The TRIP-eligible lines of insurance are defined as those lines identified for state regulatory purposes as follows: Fire, Allied Lines, Commercial Multiple Peril (non-liability), Commercial Multiple Peril (liability), Ocean Marine, Inland Marine, Workers' Compensation, Other Liability (but not including Professional Liability, which is otherwise within this line for state reporting purposes), Products Liability, Aircraft, and Boiler and Machinery. 31 C.F.R. § 50.4(w). Some of these lines also contain personal property and casualty premium exposures that are not subject to the Program. There are also certain other defined exclusions within these lines, which are outlined at 31 C.F.R. § 50.4(w)(2).

[6] Further details concerning the operation of the Program are provided in Section II of this Study.

[7] 31 U.S.C. § 313(c)(1)(D).

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TRIA originally authorized the Program for a three-year period ending December 31, 2005. The Program has since been reauthorized three times,[8] most recently in 2015 when the Terrorism Risk Insurance Program Reauthorization Act of 2015 (2015 Reauthorization Act) extended the Program through December 31, 2020.[9] Changes enacted with each Program renewal have generally reduced potential federal exposure to insured losses.

The 2015 Reauthorization Act provides that the Secretary shall conduct studies of small insurers participating in the Program, and identify any competitive challenges such small insurers face in the terrorism risk insurance marketplace.[10] The first small insurer study is to be conducted in 2017, and a second study in 2019. The 2015 Reauthorization Act also requires the Secretary to define the "small insurers" subject to these studies through regulation.[11]

TRIA requires the studies of small insurers to include analyses of:

(1) Changes to the market share, premium volume, and policyholder surplus of small insurers relative to large insurers;
(2) How the P/C insurance market for terrorism risk differs between small and large insurers and whether such a difference exists within other perils;
(3) The impact of the Program's mandatory availability requirement under section 103(c) on small insurers;
(4) The effect of increasing the trigger amount for the Program under section 103(e)(1)(B) on small insurers;
(5) The availability and cost of private reinsurance for small insurers; and
(6) The impact that State workers' compensation laws have on small insurers and workers' compensation carriers in the terrorism risk insurance marketplace.[12]

The Secretary is required to submit a report to the Congress setting forth the findings and conclusions of each small insurer study.

This Study addresses Treasury's initial findings and conclusions on small insurer competitiveness. Based on data collected to date, and as described in the Study, Treasury has identified several areas for further investigation. As Treasury collects more data over subsequent

[8] Terrorism Risk Insurance Extension Act of 2005, Pub. L. 109-144, 119 Stat. 2660; Terrorism Risk Insurance Program Reauthorization Act of 2007, Pub. L. 110-160, 121 Stat. 1839; Terrorism Risk Insurance Program Reauthorization Act of 2015, Pub. L. 114-1, 129 Stat. 3.

[9] Treasury has issued rules to implement changes to TRIA under the 2015 Reauthorization Act, and for other purposes. *See* 81 Fed. Reg. 88592 (December 7, 2016) (Certification Interim Final Rule); 81 Fed. Reg. 93756 (December 21, 2016) (Program Final Rules except Certification).

[10] TRIA § 108(h).

[11] TRIA § 108(h)(1). The small insurer definition was adopted by Final Rule in December 2016. *See* 81 Fed. Reg. 93756, 93757-59 (December 21, 2016).

[12] TRIA § 108(h).

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years, enabling more sophisticated analysis of market changes, it will refine its observations and conclusions regarding competitiveness issues possibly faced by small insurers participating in the terrorism risk insurance marketplace. Treasury will also assess whether changes to the TRIP data call are warranted to provide additional information for its 2019 study.

II. The Terrorism Risk Insurance Program

The Program requires that each entity meeting the definition of an insurer make available coverage for insured losses resulting from acts of terrorism.[13] This offer must "not differ materially from the terms, amounts, and other coverage limitations applicable to losses arising from events other than acts of terrorism." The "make available" requirement applies only to TRIP-eligible lines of insurance.[14] TRIA does not mandate that insurers offer terrorism risk insurance for any particular price,[15] nor does TRIA require any policyholder to purchase insurance for terrorism risk.[16]

Insurers are eligible for federal payments under the Program only for losses resulting from "acts of terrorism." An "act of terrorism" is defined under TRIA as an act certified by the Secretary, in consultation with the Attorney General of the United States and the Secretary of Homeland Security:

- 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;[17] and
- to have been committed by an individual or individuals, 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 U.S. government by coercion.[18]

Additionally, the Secretary shall not certify an act that was either committed as part of the course of a war declared by Congress,[19] or that does not result in P/C insurance losses exceeding $5 million.[20] If the Secretary certifies an act of terrorism, participating insurers may submit claims

[13] An insurer is defined under TRIA as any entity, including any affiliate thereof, which receives direct earned premiums for TRIP-eligible lines of insurance and is licensed or admitted to engage in the business of insurance in any state; an eligible surplus lines carrier; a federally-approved maritime, energy, or aviation insurer; a state residual market insurance entity or workers' compensation fund; or, to the extent provided in rules issued by the Secretary, a captive insurer or a self-insurance arrangement. TRIA § 102(6).

[14] Reinsurance is excluded from the TRIP-eligible lines of insurance. TRIA § 102(11)(B)(vii). Issues concerning small insurers' use of private reinsurance and the Program are discussed further below at Section IV.E.

[15] State insurance rating laws and regulations may affect the price that can be charged by insurers writing terrorism risk insurance subject to TRIA.

[16] In some circumstances, state law may require the purchase of (or limit the ability to exclude) coverage for terrorism risk, such as in the case of workers' compensation insurance, discussed further below in Section IV.F.

[17] TRIA also provides that an act may occur outside the United States in the case of certain air carriers or vessels, or on the premises of a U.S. mission. TRIA § 102(1)(A)(iii).

[18] TRIA § 102(1)(A).

[19] This limiting clause regarding an act of war does not apply to coverage for workers' compensation insurance. TRIA § 102(1)(B)(i).

[20] TRIA § 102(1)(B)(ii).

to Treasury and Treasury will determine whether, and in what amounts, insurers are eligible for payments under the Program.[21]

A participating insurer's recovery under the Program is based on application of its individual insurer deductible, the Program Trigger, the federal share of compensation of an insurer's losses, and the Program Cap. Treasury may obtain reimbursement of any payments of the federal share of compensation that it makes based upon the recoupment process. Finally, Treasury has adopted a definition of "small insurers" to guide its analysis of any competitive challenges that such small insurers may face in the terrorism risk insurance marketplace.

Insurer Deductible

Two pre-requisites must be met before an insurer is eligible for payments from Treasury under the Program: the insurer's losses must exceed its deductible, and the Program Trigger must be satisfied. An individual insurer will not be eligible to receive federal payments unless its losses exceed its deductible, which is 20 percent of the insurer's direct earned premium (DEP) in the TRIP-eligible lines for the prior calendar year.[22]

Program Trigger

The Program Trigger is the minimum amount of aggregate industry insured losses resulting from an act (or acts) of terrorism that must occur in a calendar year before any federal payments are made. The Program Trigger was $120 million in calendar year 2016;[23] it increases by $20 million per year thereafter until it reaches $200 million in 2020.[24]

Federal Share of Compensation

After an insurer meets its insurer deductible and the Program Trigger is satisfied, the federal government will pay a certain percentage of that insurer's losses in excess of the insurer's deductible. For calendar year 2016, the federal share of compensation was set at 84 percent of an insurer's losses above its deductible, with the insurer responsible for the remaining 16 percent. The federal share of compensation will continue to decrease (and the insurer share will

[21] Any determination by Treasury is made pursuant to the Program regulations. *See* 31 C.F.R. Part 50.

[22] TRIA § 102(7).

[23] The 2015 Reauthorization Act provided for certain changes in Program mechanics from the date of the 2015 Reauthorization until the expiration date for the Program in 2020. This Study focuses upon the Program structure in place in 2016 because much of the Study's analysis is based on the 2017 TRIP data call, which uses year-end 2016 data.

[24] TRIA § 103(e)(1)(B). TRIA did not originally have a Program Trigger. This requirement was introduced in the 2005 Program reauthorization. It was initially set at $50 million (for losses occurring in 2006), and increased to $100 million for losses occurring in 2007. When TRIP was reauthorized through 2014, no change was made to the Program Trigger, which remained at $100 million. The 2015 Reauthorization Act, however, provides for an annual increase in the Program Trigger beginning in 2016.

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increase) by one percentage point per year through 2020, at which time the federal share will be 80 percent and the insurer co-participation share will be 20 percent.[25]

Program Cap

TRIA limits the aggregate exposure of both insurers and the federal government arising from insured losses for an act or acts of terrorism. Specifically, TRIA prohibits the Secretary from making payments for any portion of aggregate insured losses from acts of terrorism which exceed the "Program Cap" of $100 billion during any calendar year.[26] If the Program Cap is reached, an insurer that has met its insurer deductible by making payments for insured losses subject to the Program is not liable for any portion of losses that exceeds the Program Cap.[27]

Recoupment

TRIA includes a mechanism for the Secretary to collect "terrorism loss risk-spreading premiums" from insurers if federal payments are made to insurers under the Program. Under this mechanism, a process known as recoupment, insurers writing TRIP-eligible lines of insurance may be required to collect funds from policyholders by placing a surcharge on insurance policies written in those lines. These surcharges must then be remitted to the Secretary.[28] The requirement to collect, or recoup, terrorism loss risk-spreading premiums does not apply only to insurers that received federal payments under the Program, but rather applies to all insurers writing policies in TRIP-eligible lines of insurance. Surcharges are placed on insurance policies regardless of whether the policyholder elects to purchase terrorism risk insurance.[29]

Small Insurer Definition

Treasury adopted its small insurer definition as required by the 2015 Reauthorization Act[30] to provide a benchmark for any study of small insurers that would help identify any competitive challenges such small insurers might face in the terrorism risk insurance marketplace.[31] The small insurer definition specifically references the impact of the Program Trigger:

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[25] TRIA § 103(e)(1)(A).

[26] TRIA §103(e)(2)(A).

[27] TRIA requires the Secretary to notify Congress if insured losses are projected to exceed the Program Cap and in that case to determine the pro rata share of insured losses to be paid by each affected insurer. TRIA §§ 103(e)(2)-(3).

[28] TRIA §§ 103(e)(7)-(8).

[29] Depending on how any federal payments under TRIP that have been expended compare with the total insured losses paid by participating insurers, recoupment under the Program may be mandatory, or may be subject to a discretionary determination by the Secretary. *See id*.

[30] TRIA § 108(h)(1).

[31] Treasury's small insurer definition should not be viewed as having relevance to any other definition of "small insurer" that may be used in other statutory and regulatory determinations, either at the federal or state levels.

> *Small insurer* means an insurer (or an affiliated group of insurers . . .) whose policyholder surplus for the immediately preceding year . . . is less than five times the Program Trigger amount for the current year and whose direct earned premium for the preceding year is also less than five times the Program Trigger amount for the current year. An insurer that has not had a full year of operations during the immediately preceding calendar year is a small insurer if its policyholder surplus in the current year is less than five times the Program Trigger amount for the current year. A captive insurer is not a small insurer, regardless of the size of its policyholder surplus or direct earned premium.[32]

Significance of the Program Trigger for Small Insurers

For an insurer above the small insurer size threshold, the Program Trigger has no practical impact. This is because once an insurer of this size has satisfied its insurer deductible, those losses will be sufficient to satisfy the Program Trigger as well. Such an insurer will be entitled to submit claims for the federal share of compensation for any amount in excess of its insurer deductible.

For a small insurer, however, the Program Trigger might pose a very significant consideration. This is because a small insurer may pay insured losses that are in excess of its insurer deductible that do not, in and of themselves, satisfy the Program Trigger. For example, if in 2016 an insurer had a deductible of $20 million (because its DEP in 2015 was $100 million), and paid total insured losses of $60 million, the insurer would not be entitled to payments under the Program for losses above its deductible (in this example, $40 million) unless total insured losses across all Program participants from an act or acts of terrorism were above the Program Trigger of $120 million. If this hypothetical insurer were the only insurer that sustained insured losses, it would not be able to collect any portion of the $40 million above its deductible because the Program Trigger had not been satisfied.

[32] 31 C.F.R. § 50.4(z).

III. The Data Collection Process

TRIA requires Treasury to collect data related to the Program.[33] Treasury uses this data, among other things, to prepare required studies and reports concerning the effectiveness of the Program and small insurer competitiveness in the terrorism risk insurance marketplace. This Study is based primarily on the results of Treasury's 2017 TRIP data call. In addition, Treasury performed qualitative research and sought input from stakeholders, including small insurers, other Program participants, state regulators, the National Association of Insurance Commissioners, and the general public.[34] When analyzing certain market changes over time for this Study, Treasury also considered information reported by insurers to state regulators.

The 2017 TRIP data call was mandatory for participating insurers,[35] subject to an exception for small insurers that wrote less than $10 million in TRIP-eligible lines premium in calendar year 2016.[36] For the purposes of the 2017 TRIP data call and this Study, small insurers were considered to be (pursuant to the small insurer definition) insurers with a 2015 policyholder surplus of under $600 million and 2015 TRIP-eligible direct earned premium of under $600 million, which is five times the 2016 Program Trigger of $120 million.

Treasury collected information on a group basis from multiple affiliated companies because TRIP is generally administered on a group basis. The information collected included data concerning premium, policy exposures, and reinsurance. Treasury also collected data to evaluate policyholder take-up rates for terrorism risk insurance offered by small insurers. Treasury collected similar information from other industry segments, such as larger licensed insurers above the small insurer threshold (or "non-small insurers"), captive insurers, and alien surplus lines insurers.

Treasury collected data through a third-party insurance statistical aggregator, as provided for under the 2015 Reauthorization Act.[37] The statistical aggregator provided results to Treasury in an aggregated, anonymous format that did not identify any particular reporting insurer. Treasury obtained most of the workers' compensation insurance elements from the National Council on Compensation Insurance (providing data from the states in which it operates as well as on behalf of other independent state workers' compensation rating bureaus) and the California Workers'

[33] TRIA § 104(h).

[34] *See* 81 Fed. Reg. 95310 (December 27, 2016).

[35] Insurers that are not small insurers are subject to different reporting templates that request more information. In the 2017 TRIP data call, Treasury has permitted insurers that did not complete the small insurer template to report the balance of the information unrelated to this Study no later than October 1, 2017.

[36] Treasury estimates that insurers eligible for this reporting exception (approximately 400 in total) represent 0.5 percent of the TRIP-eligible lines premium market, and 4.5 percent of the small insurer market segment. *See* SNL Financial (as of April 13, 2017).

[37] TRIA § 104(h)(3). The data aggregator for the 2017 TRIP data call was Insurance Services Office, Inc.

Compensation Insurance Rating Bureau, thereby reducing the reporting requirements on the industry.

Treasury is required annually to collect information relating to terrorism risk insurance from all participating insurers, including captive insurers[38] and alien surplus lines insurers.[39] Treasury specifically excluded captive insurers from the definition of small insurers, so such insurers were not subject to this Study's analysis of small insurers.[40] Although alien surplus lines insurers were not excluded from the "small insurer" definition, they only participate in the surplus market where the coverages and policyholders insured on a surplus lines basis may differ significantly from risks placed in the admitted market.[41] Therefore, to ensure that the issues identified in the 2015 Reauthorization Act are appropriately addressed, this Study does not address how alien surplus lines insurers participate in the terrorism risk insurance marketplace, or how their participation compares with that of those small insurers that Treasury analyzed.

Based on comparisons to data collected by state regulators, Treasury estimates that insurers reporting in the 2017 TRIP data call comprise at least 88 percent, by premium, of the insurer groups or companies expected to report on the small insurer data template, and at least 98 percent, by premium, of the insurer groups or companies expected to report on the non-small insurer data template. Some portion of the amounts below 100 percent may be attributable to the fact that the analysis was based upon available state data that included certain premium that was not subject to the Program. Treasury will continue to analyze whether more detailed information is available.

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[38] TRIA regulations define captive insurers as insurers licensed under the captive insurance laws or regulations of any state (31 C.F.R. § 50.4(g)); they are typically formed to insure the risks of parent or other affiliated entities.

[39] Alien surplus lines insurers are non-U.S. insurers that have been qualified by state regulators to participate in U.S. insurance markets on a surplus lines basis. Alien surplus lines insurers do not write in the admitted market, which is comprised of insurers licensed to do business in a particular jurisdiction and are subject to its laws and regulations concerning the provision of insurance coverage. This means that alien surplus lines insurers are only allowed to write insurance for risks that cannot be placed with domestic licensed insurers in the admitted market. *See* 31 C.F.R. § 50.4(o)(1)(i)(B).

[40] *See generally* 81 Fed. Reg. 18950, 18952-53 (April 1, 2016); 81 Fed. Reg. 93756, 93757-58 (December 21, 2016).

[41] Although U.S. "small insurers" may also write insurance in the surplus market, only 7.5 percent of the individual insurers within the small insurer groups that reported in the 2017 TRIP data call identified as surplus lines insurers. In addition, because alien surplus lines insurers do not write in the admitted market, they do not participate in the market for workers' compensation insurance, which is discussed in Section IV.F.

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IV. Study of Small Insurer Competitiveness in the Terrorism Risk Insurance Marketplace

As noted above, TRIA requires the studies of small insurers to include an analysis of each of the following six areas:

A. Changes to market share, premium volume, and policyholder surplus of small insurers relative to large insurers;
B. How the P/C insurance market for terrorism risk differs between small and large insurers and whether such a difference exists within other perils;
C. The impact of the Program's mandatory availability requirement under Section 103(c) on small insurers;
D. The effect of increasing the trigger amount for the Program under Section 103(e)(1)(B) on small insurers;
E. The availability and cost of private reinsurance for small insurers; and
F. The impact that State workers' compensation laws have on small insurers and workers' compensation carriers in the terrorism risk insurance marketplace.

This Study analyzes each of these areas. Treasury will continue to analyze these areas in its small insurer study to be issued in 2019.

A. Analysis of Changes to Market Share, Premium Volume, and Policyholder Surplus

This part of the Study examines changes to market share, premium volume, and policyholder surplus of small insurers relative to large insurers. For purposes of this Study, Treasury identified "large insurers" as those insurers larger than the small insurer size threshold and which completed the "non-small" data collection template. The Study analyzes the changes for small insurers from 2006 through 2016 because these are the years during which TRIP has been subject to a Program Trigger, which Treasury uses as a basis for defining small insurers.[42] However, the 2017 TRIP data call, addressing 2016 year-end information, was the first year of mandatory data collection by Treasury.[43] As discussed below, Treasury reviewed state reporting

[42] *See* above at Section II. Although the small insurer definition was not adopted until 2016, Treasury performed this analysis from 2006 to 2016 based on the number of insurers that would have been considered to be "small insurers" under the Program, if the "small insurer" definition had been in effect since 2006.

[43] Treasury performed a data collection in 2016; however, because it was the first year of data collection under the 2015 Reauthorization Act, Treasury made participation in the collection voluntary to reduce the imposition of undue burdens on insurers. *See* 81 Fed. Reg. 11649 (March 4, 2016). Insurers representing approximately 41 percent of the entire terrorism risk insurance market (by premium) responded to the 2016 voluntary data call. Because of the more limited response in the 2016 data call, the Study does not compare results from the 2016 voluntary data call and the 2017 mandatory data call. For more information about the 2016 voluntary data call, *see* "Report on the Overall Effectiveness of the Terrorism Risk Insurance Program," U.S. Department of Treasury (June 2016) (2016 Effectiveness Report), *available at* https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/2016_TRIP_Effectiveness_%20Report_FINAL.pdf.

data to draw conclusions for the period from 2006 through 2016, and considered the extent to which this reporting data could be used as a proxy for information collected through a mandatory data collection.

State insurance regulators collect information for P/C lines of insurance from insurers licensed in their respective jurisdictions. This collection by state regulators has not historically included information specific to the terrorism risk insurance component of P/C insurance policies. However, the information collected by state regulators does identify premiums collected by lines of insurance in the state insurance reporting lines. To the extent possible, Treasury has defined TRIP-eligible lines of insurance by reference to state insurance reporting lines; however, there are some differences between the TRIP-eligible lines of insurance and the same lines when used for state reporting purposes. This is because the state reporting lines include certain premium that is not subject to the Program. In the 2017 TRIP data call, the premium reported by small insurers to Treasury for calendar year 2016 was approximately 83 percent of the reported figure made by the same cohort of insurers in the TRIP-eligible lines for state reporting purposes.[44] This 17 percent difference represents premium that those small insurers reported to state regulators, across the various lines, that is not subject to the Program.

The use of the state reporting data for this part of the Study allows for some comparisons to be made from 2006 to 2016; however, it also has some limitations. First, Treasury adjusted the data to account for the premium differential between the TRIP-eligible lines of insurance and the state reporting lines from 2006 to 2016. This was done by assuming that similar amounts of premium in the state reporting lines from 2006 to 2016 represented premium not subject to the Program but still reported for state purposes. Second, the state reporting data used in this analysis was not specific to terrorism risk. Third, the premium writings of small insurers reported in the TRIP-eligible lines of insurance that were not subject to the Program could vary disproportionately over time from the premiums reported in the lines as a whole. For purposes of this initial analysis, Treasury considers the data, as adjusted, to be instructive. Treasury will continue to analyze such market changes in the 2019 study, which will have the benefit of additional responses to future TRIP data calls.

The analysis of market changes from 2006 to 2016 was also affected by the connection between the "small insurer" definition and the Program Trigger. From 2006 to 2016, the Program Trigger increased twice, which affects the number of insurers classified as "small insurers."[45] The increase in the Program Trigger between 2006 and 2007 and between 2015 and 2016 caused the number of insurers classified as "small insurers" to increase because a greater number of insurers were below the policyholder surplus and DEP thresholds. This change in the Program Trigger corresponded with an increase in the market share of small insurers from 2006 to 2007

[44] SNL Financial (as of April 13, 2017) and 2017 TRIP data call. The principal differences are in: (1) the Fire, Allied Lines, and Inland Marine lines of insurance, which for state reporting purposes include personal lines exposures that are not subject to the Program; and (2) professional liability insurance, which is not subject to the Program, but is reported under the Other Liability line of insurance that otherwise is subject to the Program.

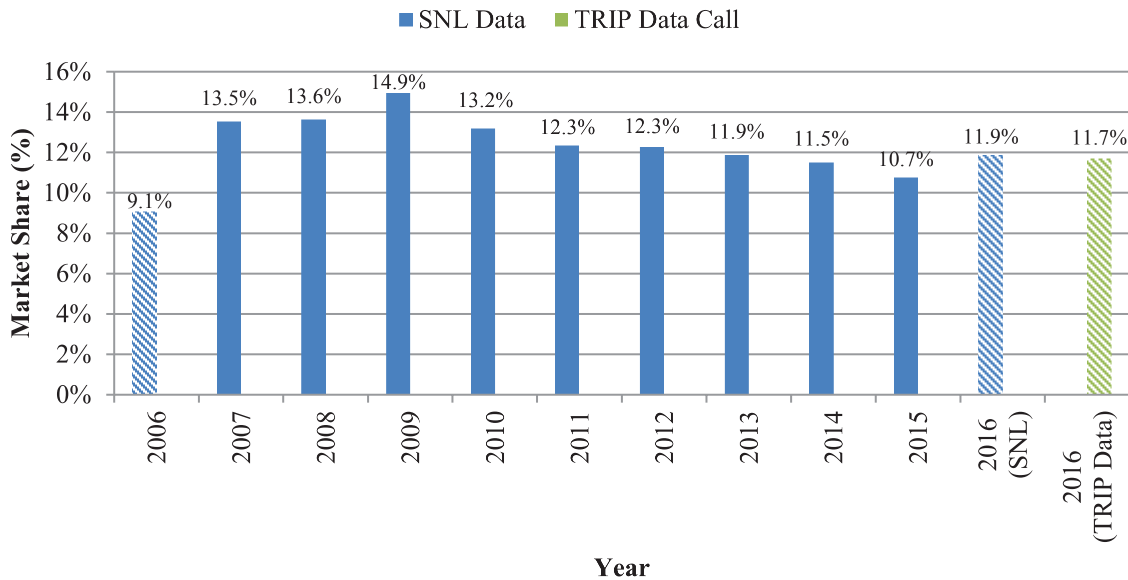
[45] *See* above at note 24.

and 2015 to 2016. This is exhibited by the cross-hatching for the columns indicating years 2006 and 2016 in Figures 1 through 3, below.

From 2007 through 2015, the Program Trigger (and the size classification identifying small insurers) did not change. Therefore, this part of the Study analyzes data regarding small insurers between 2007 and 2015.

Figure 1 illustrates the market share (based on adjusted DEP) of small insurers writing TRIP-eligible lines of insurance, from the inception of the Program Trigger requirement in 2006 through 2016. It highlights that the market share of small insurers as measured by publicly available data collected by state regulators (as adjusted for this analysis) was approximately 11.9 percent in 2016. This figure compares to the market share figure based on the 2017 TRIP data call of 11.7 percent for small insurers. This market share is measured as a percentage of the total data reported by small and non-small insurers under the 2017 TRIP data call.

Figure 1: Market Share by DEP of Small Insurers in TRIP-Eligible Lines (2006-2016)

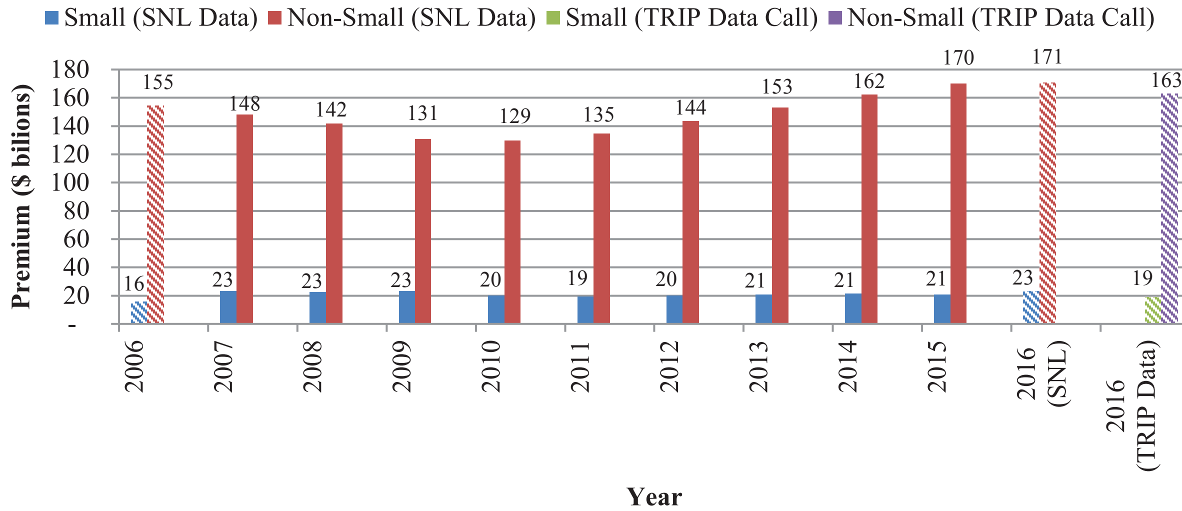


Source: SNL Financial and 2017 TRIP Data Call

Figure 1 also shows that, based on the data used in this analysis, the small insurer market share declined from 13.5 percent to 10.7 percent between 2007 and 2015.

Figure 2 illustrates the premium volume comparison for TRIP-eligible lines for small insurers and non-small insurers from 2006 to 2016. As shown in Figure 2, small insurer premium receipts declined from 2007 to 2015 (from $23 billion to $21 billion). Non-small insurers had increased premiums over this period, which resulted in the gradual decline in market share for small insurers observed above.

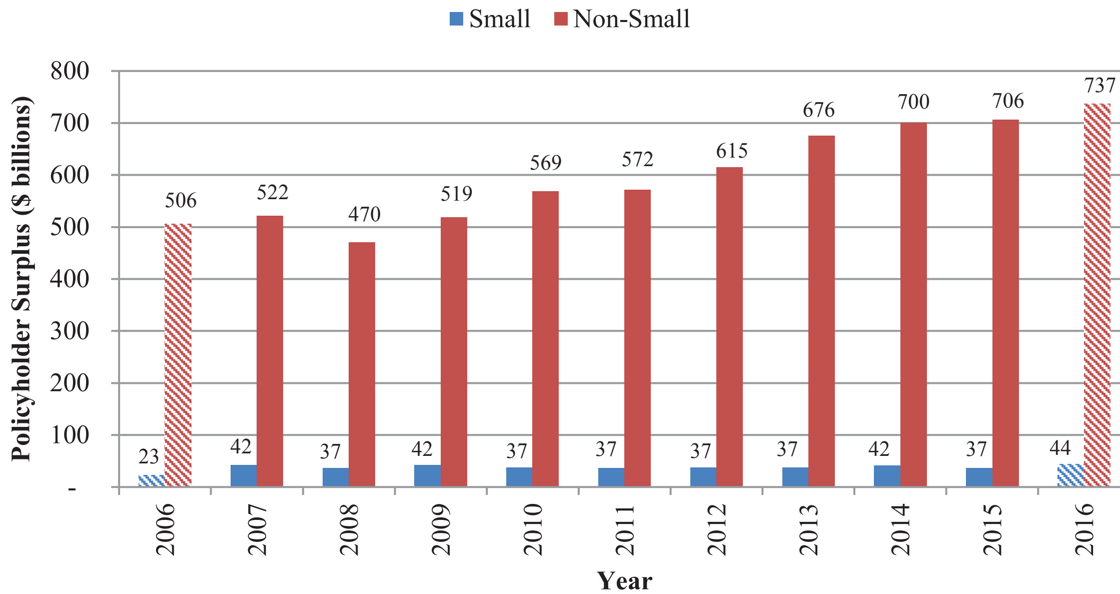
**Figure 2: Premium Volume Comparison for TRIP-Eligible Lines
Small Insurers vs. Non-Small Insurers**



Source: SNL Financial and 2017 TRIP Data Call

Figure 3 illustrates the policyholder surplus comparison for small insurers and non-small insurers from 2006 to 2016. During the 2007 to 2015 period, the policyholder surplus of small insurers was within the range of $42 billion to $37 billion. The policyholder surplus of non-small insurers generally increased over the same period.

**Figure 3: Policyholder Surplus Comparison
Small Insurers vs. Non-Small Insurers**



Source: SNL Financial

In the absence of specific historical terrorism risk insurance data from 2007 to 2015, this Study's use of the state-reported TRIP-eligible lines data for the 2007 to 2015 period is only a proxy for market share information during this period. Based upon this information, however, the market share of small insurers (measured by TRIP-eligible lines premium) experienced a decline relative to the market share of non-small insurers. During the 2007 to 2015 period, the premiums received by small insurers declined, while the premiums received by non-small insurers increased. Policyholder surplus for small insurers during that same period also declined, while the policyholder surplus of non-small insurers increased. As it obtains additional information that is more specific to terrorism risk insurance from future TRIA data calls, Treasury will continue to analyze these areas in subsequent studies.

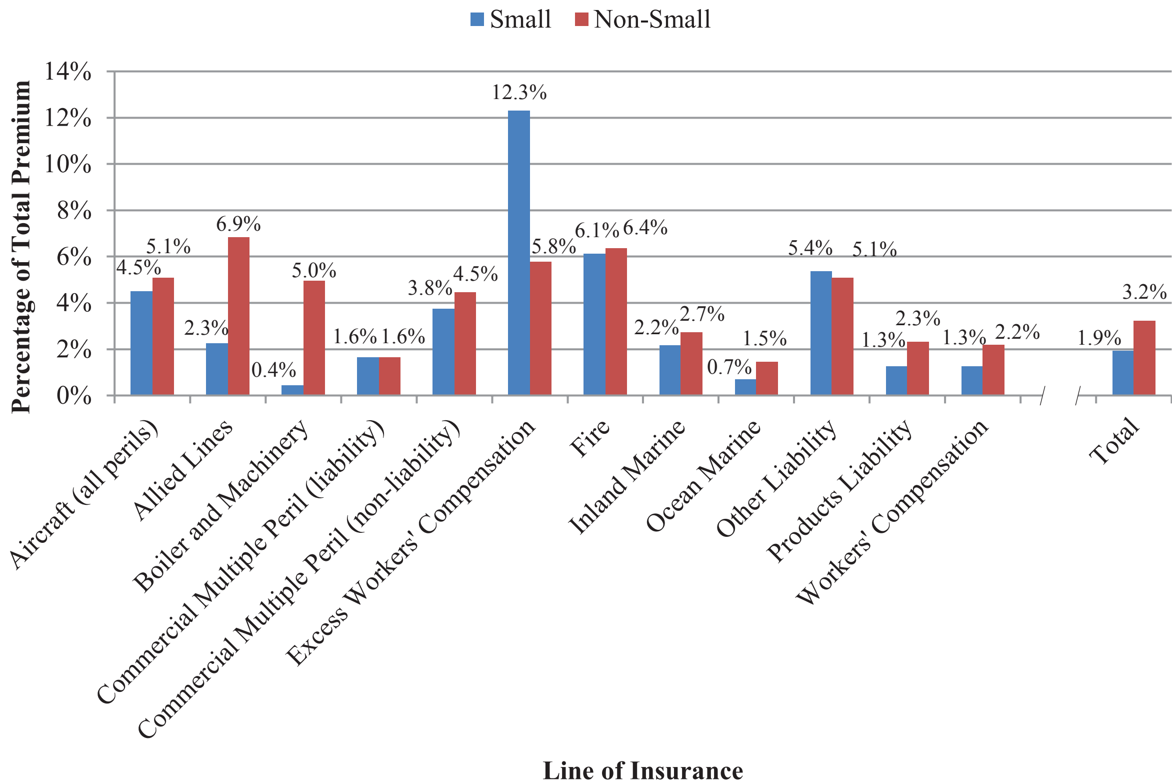
B. Market Differences between Small Insurers and Large Insurers in the Terrorism Risk Insurance Marketplace and Comparison to Other Perils

Information collected through Treasury's 2017 TRIP data call provided new information regarding the role of small insurers in the market for terrorism risk insurance. Based upon that information, this section analyzes premium, take-up rates, geographic scope of writings, and the lines of insurance in which small insurers are more heavily concentrated and comprise a larger share of the overall market.

The price of terrorism risk insurance can be expressed as the percentage of the overall commercial P/C policy premium that is allocated to terrorism risk insurance. In some cases, terrorism risk insurance is provided under commercial P/C policies at no additional charge.

Figure 4 shows, for both small insurers and non-small insurers, the percentage of overall premium charged for terrorism risk insurance. Figure 4 does not include commercial P/C policies where the insurer did not include any charge for terrorism risk insurance.

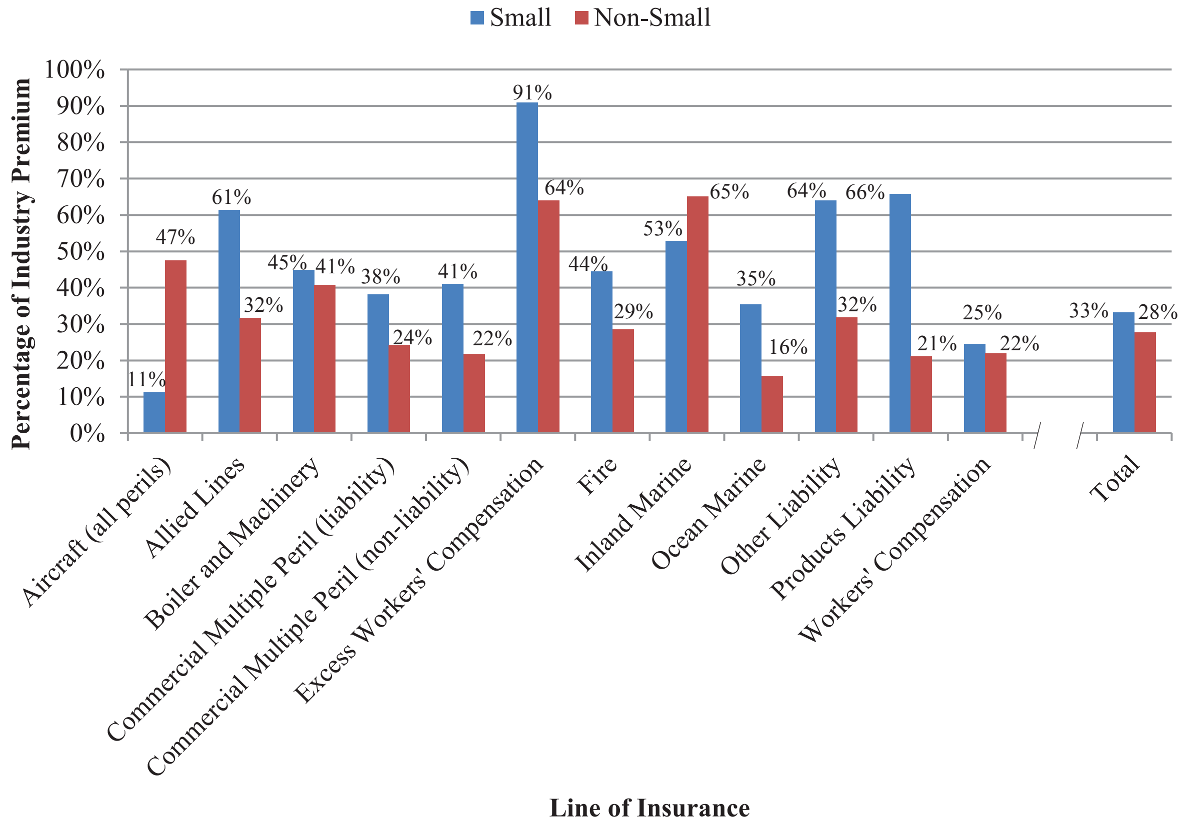
Figure 4: Percentage of Overall Premium Charged for Terrorism Risk Insurance (by Line of Insurance)
Small Insurers vs. Non-Small Insurers



Source: 2017 TRIP Data Call

Figure 5 shows the extent to which small insurers and non-small insurers did not include any charge for terrorism risk insurance. Figure 5 illustrates that, in most lines, small insurers were more likely to include no charge for terrorism risk insurance than were non-small insurers.

Figure 5: $0 Premium Charged for Terrorism Risk Insurance
Small Insurers vs. Non-Small Insurers

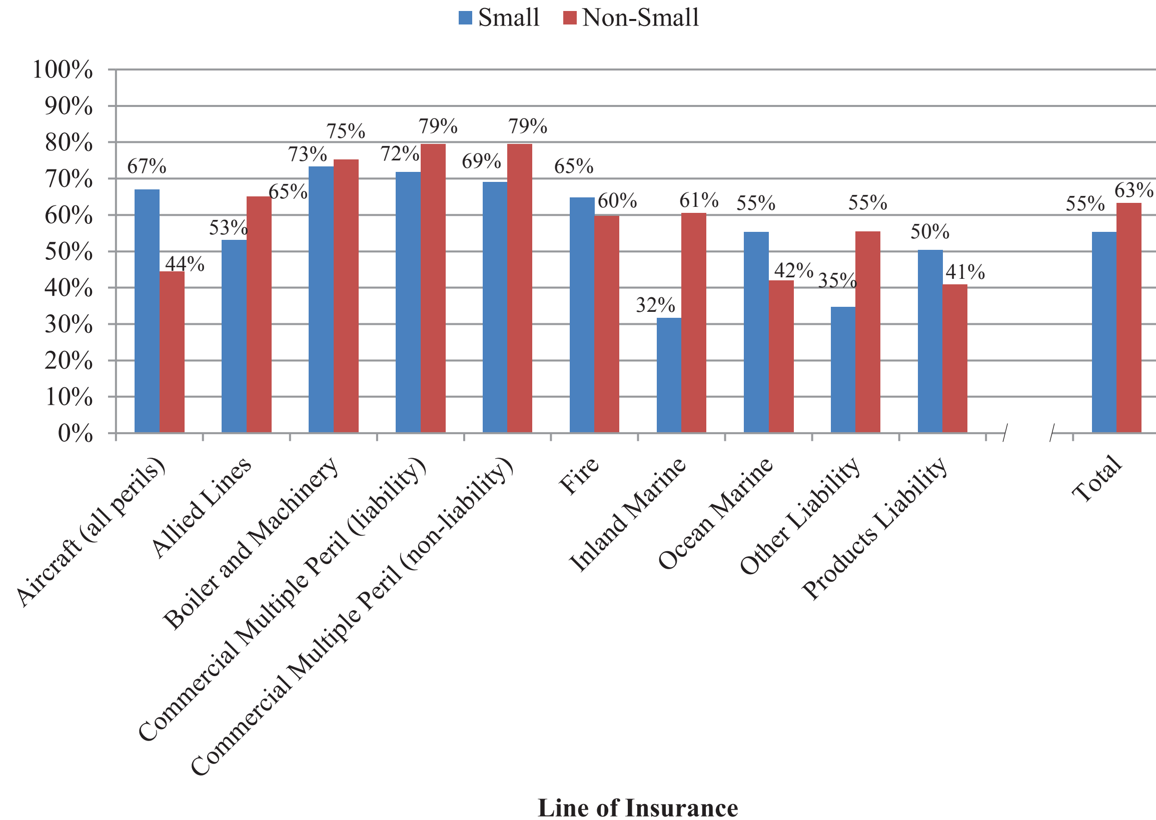


Source: 2017 TRIP Data Call

Based on the data received in the 2017 TRIP data call, Figures 4 and 5 illustrate that small insurers charged proportionally less premium for terrorism risk insurance than non-small insurers. As Figure 4 illustrates, when a premium is charged for terrorism risk insurance, the percentage of the total policy premium relating to terrorism risk premium for small insurers is, for most lines, smaller than the percentage indicated for larger insurers. Measured against all TRIP-eligible lines combined, small insurers charge a lower premium than non-small insurers. Figure 5 also demonstrates that small insurers are more likely than non-small insurers to charge no premium for terrorism risk insurance. However, it should be noted that the available data does not provide any information concerning the nature of the risks being insured, which will affect the premium being charged.

Figure 6 illustrates the take-up rates for terrorism risk insurance for small insurers and non-small insurers. Figure 6 demonstrates the difference between small insurers and non-small insurers in the take-up rates for terrorism risk insurance by their policyholders. When measured by premium, the policyholder take-up rate for policies written by small insurers was generally lower, in most individual lines as well as in the TRIP-eligible lines of insurance as a whole, than that of non-small insurers.

Figure 6: Take-Up Rates for Terrorism Risk Insurance
Small Insurers vs. Non-Small Insurers[46]



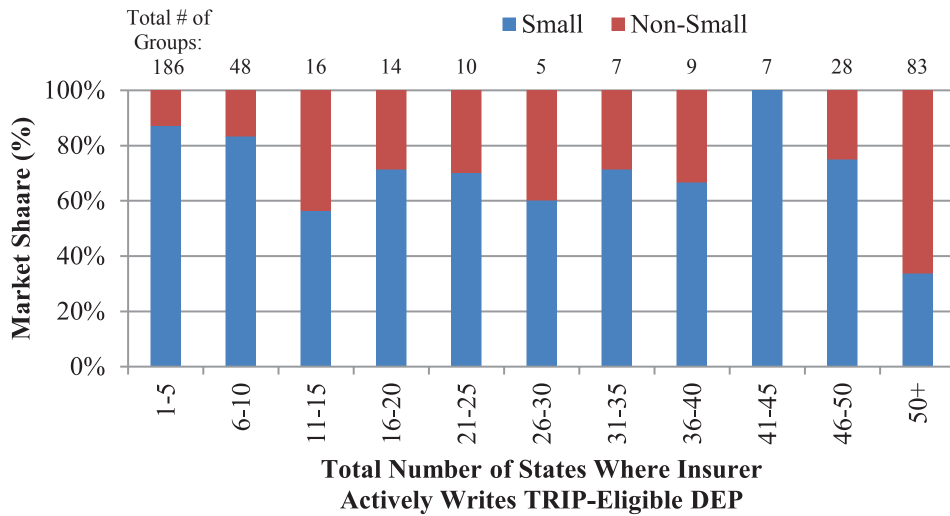
Source: 2017 TRIP Data Call

Figure 7 illustrates the geographic scope of written premiums for small insurers and non-small insurers, and reflects that small insurers insure risks within a smaller geographic footprint than larger insurers. Figure 7 compares the geographic scope of small insurers to that of non-small insurers. Based on the data, small insurers appear to operate on a regional basis in a smaller number of states than non-small insurers, even though they may have a significant presence in individual local markets.[47]

[46] This figure includes take-up rates for all TRIP-eligible lines except workers' compensation. As a matter of state law, workers' compensation policies must provide coverage for terrorism risk, and the effective take-up rate for this line is therefore 100 percent. *See* Section IV.F (discussing workers' compensation insurance).

[47] *See* Atlantic Charter's remarks to the Advisory Committee on Risk-Sharing Mechanisms (March 31, 2017) (Atlantic Charter Remarks), p. 7, *available at* https://www.treasury.gov/initiatives/fio/acrsm/Documents/Presentation_Atlantic_Charter.pdf.

Figure 7: Geographic Scope of Written Premiums
Small Insurers vs. Non-Small Insurers



Source: SNL Financial

Figure 8 shows that the TRIP-eligible insurance of small insurers is more heavily concentrated in certain lines of insurance than is the case for non-small insurers, and as a result, such small insurers have a larger share of the overall market in these lines. Figure 8 illustrates that small insurers write a larger portion of their TRIP-eligible lines premium within: (1) the commercial multi-peril (CMP) lines; and (2) the workers' compensation line, as compared to larger insurers. CMP products provide coverage for multiple lines of insurance within a single policy, and tend to be marketed towards small- to medium-sized businesses.[48] Workers' compensation insurance, which is discussed in greater detail in Section IV.F below, provides insurance for workplace injury benefits available under state workers' compensation systems.

[48] *See generally* "Understanding Business Owners Policies (BOPs)," Insurance Information Institute, *available at* http://www.iii.org/article/understanding-business-owners-policies-bops.

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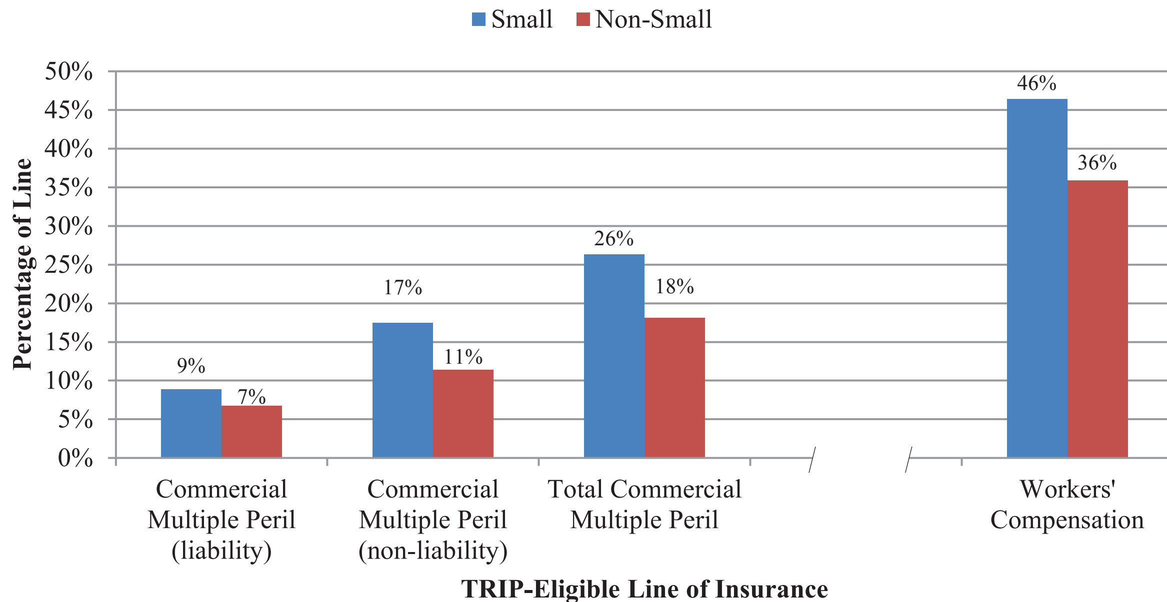
Figure 8: Percentage of TRIP-Eligible Lines Premium Written within the CMP and Workers' Compensation Lines
Small Insurers vs. Non-Small Insurers



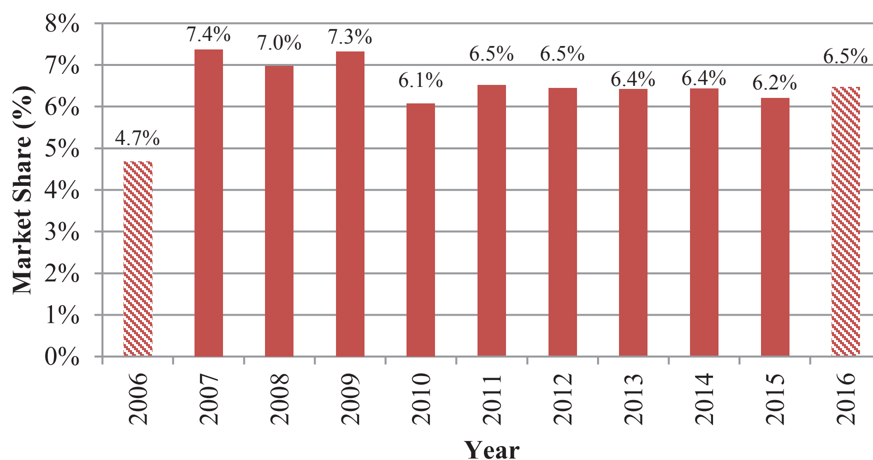
Source: 2017 TRIP Data Call

The information collected in the 2017 TRIP data call shows differences between the participation of small insurers and non-small insurers in the terrorism risk insurance marketplace. This information did not reflect any particular differences presented by other perils.[49] However, for purposes of this comparison, it may be instructive to examine market share information for small insurers in the P/C lines of insurance that are not subject to the Program.

Figure 9 provides the market share, by DEP, of small insurers and non-small insurers in P/C lines not subject to TRIP. Based on the data reported to state regulators, Figure 9 illustrates that the market share of small insurers measured by DEP in P/C lines of insurance not subject to the Program decreased from 7.4 percent in 2007 to 6.2 percent in 2015.

[49] For the reasons discussed in this Study, terrorism risk insurance presents a number of issues that are limited to the terrorism risk insurance marketplace, such as in the areas of aggregation of losses and workers' compensation insurance.

Figure 9: Market Share (DEP) of Small Insurers in P/C Lines of Insurance Not Subject to TRIP (2006-2016)



Source: SNL Financial

C. Mandatory Availability Requirement

This Study is an initial analysis of the impact of the mandatory availability requirement on the market competitiveness of small insurers. Treasury did not receive any formal public comments on this subject when it sought input for the Study in the Federal Register.[50] Treasury is not making conclusions regarding this issue in this Study, and will continue to evaluate whether the mandatory availability requirement is having any market impacts on small insurers in the TRIP-eligible lines of insurance.

The mandatory availability requirement under TRIA requires insurers offering certain lines of commercial P/C insurance for U.S. risks to "make available" coverage for terrorism risk on terms that do not differ materially from the terms, amounts, and coverage limitations applicable to losses arising from events other than acts of terrorism.[51] TRIA does not place pricing restrictions on insurers,[52] although state law rating requirements may define or limit what an insurer may charge for terrorism insurance. If the prospective policyholder does not accept the mandatory offer, the parties may negotiate a different arrangement for terrorism risk coverage which is not on the same terms as provided for other risks.[53] To the extent an insurer does not regularly offer coverage for a particular risk under a line of insurance (for example, with respect to losses arising from Nuclear, Biological, Chemical or Radiological (NBCR) events), it is not required to offer coverage for these risks because of the mandatory availability requirement.[54] Additionally,

[50] *See* 81 Fed. Reg. 95310 (December 27, 2016).

[51] TRIA § 103(c); 31 C.F.R. §§ 50.20(a), 50.22(a).

[52] *See* 31 C.F.R. § 50.22(a).

[53] 31 C.F.R. § 50.21(c).

[54] TRIA § 103(c)(2); *see* 31 C.F.R. § 50.22(b).

as a condition for receiving federal payments under the Program, participants must meet certain documentation requirements under TRIA and its implementing regulations concerning compliance with the mandatory availability requirement.

Because terrorism risk insurance must be offered in connection with P/C insurance lines subject to TRIP, the mandatory availability requirement could have an impact on the manner in which such insurance is underwritten. For example, one difficulty with insuring losses arising from acts of terrorism is the aggregation risk potentially presented by an act of terrorism. A large-scale terrorist event can have a significant impact across multiple lines of insurance, and affect a large number of insured risks within a limited geographic area.

Among other options, insurers may tend to manage aggregation of the risk that they assume within a particular geographic area, or within proximity to a location considered to be a potential target for terrorist activity. Insurers of all sizes may employ this analysis when deciding whether to write policies that are subject to terrorism risk.[55]

Additional factors that are external to TRIA may also influence whether insurers offer terrorism risk insurance, irrespective of the mandatory availability requirement. First, in a number of lines of insurance and jurisdictions, terrorism risk insurance must be provided under state law.[56] In these situations an insurer must offer terrorism risk insurance – irrespective of the mandatory availability requirement. Second, the ability to offer terrorism risk insurance with other coverages may be important in order to compete in certain U.S. insurance markets, in particular those defined by large metropolitan areas. Take-up rates for terrorism risk insurance vary by jurisdiction and locality, and higher percentages of policyholders generally purchase terrorism risk insurance in major metropolitan areas.[57]

Treasury will continue to analyze this issue and report on the subject in 2019.

D. Impact of the Increasing Program Trigger Amount

This section considers the impact on small insurers of increasing the Program Trigger, and assesses this impact over time.

Two thresholds must be satisfied before a participating insurer will be eligible for federal payments in connection with insured losses arising from an act of terrorism. First, an insurer

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[55] *See generally* "Terrorism Risk Insurance: Market Challenges May Exist for Current Structure and Alternative Approaches (GAO-17-62)," U.S. Government Accountability Office (January 2017), pp. 18-19, *available at* http://www.gao.gov/assets/690/682064.pdf.

[56] The principal example here is the workers' compensation line of insurance. *See* Section IV.F.

[57] *See, e.g.*, "2016 Terrorism Risk Insurance Report," Marsh & McLennan Companies (July 2016), p. 10 (a "higher percentage of companies in the Northeast (72%) purchased property terrorism insurance than in any other region, likely attributable to the concentration of large metropolitan areas, including Washington, DC, and New York"), *available at* https://www.marsh.com/content/dam/marsh/Documents/PDF/US-en/2016%20Terrorism%20Risk%20Insurance%20Report.pdf.

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must satisfy its TRIP deductible, which is 20 percent of its TRIP-eligible premium earned during the previous calendar year.[58] Second, even if a particular insurer satisfies its individual deductible, the total aggregate insured losses across the industry must exceed the Program Trigger before any federal payments can be made.

Thus, an insurer with a deductible lower than the Program Trigger could satisfy its deductible, but have its losses fall short of satisfying the Program Trigger. There could also be cases in which other participating insurers will also experience losses from the same act or acts of terrorism, and together their combined losses will satisfy the Program Trigger, such that a small insurer that has exceeded its own deductible will be able to obtain a recovery. Nonetheless, the Program Trigger requirement could operate to preclude recovery for one or more small insurers, in a way that larger insurers may not face.

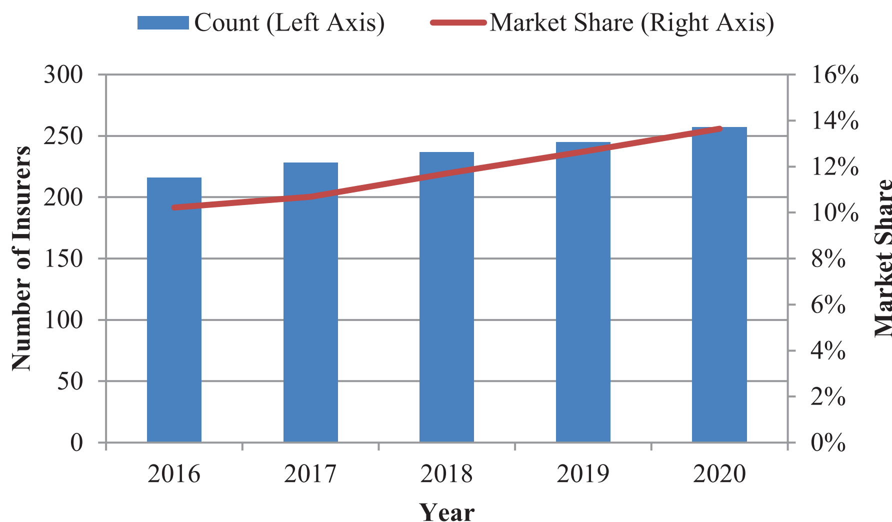
There are more than 200 domestic U.S. insurance groups subject to the TRIA data call that are currently classified as small insurers that could be subject to this exposure.[59] Figure 10 provides a projection of the potential increase in the number of small insurers caused by the prospective increase in the Program Trigger through 2020.[60] Figure 10 illustrates that an increasing number of insurers will be subject to this potential exposure over the next few years. As shown in Figure 10, Treasury projects that the number of "small insurers" is likely to increase in the future based on the assumption that the Program Trigger will increase at a rate faster than likely market growth in TRIP-eligible lines premium and policyholder surplus.

[58] TRIA § 102(7); *see* Section II above.

[59] This analysis does not include those small insurers that write TRIP-eligible lines premium of less than $10 million that were excused from reporting. This subset of insurers also could be affected.

[60] This projection of the increase in the number of small insurers caused by the projected market growth of TRIP-eligible lines DEP and policyholder surplus is based upon Treasury's analysis of 2017-2020 Gross Domestic Product forecasts to model DEP and policyholder surplus changes for individual insurance groups writing TRIP-eligible lines premium.

Figure 10: Projection of Potential Increase in Number of Small Insurers Due to Increase in Program Trigger



Source: SNL Financial

Therefore, based on the projection that the Program Trigger is increasing at a rate faster than insurer deductibles are likely to grow in the future, more insurers over time could experience losses that satisfy their Program deductible, but do not satisfy the Program Trigger. These losses would remain ineligible for federal reimbursement. In addition, insurers currently classified as small insurers will be further removed from the Program Trigger over time because the difference between their deductibles and the Program Trigger will increase. Therefore, small insurers could be more likely to incur a loss in excess of their deductibles, yet not large enough to satisfy the conditions for federal reimbursement under the Program.

Based on the 2017 TRIA data call, the Program Trigger has an impact on small insurers participating in the Program that is not faced by larger insurers. Commenters observed that this effect on small insurers, which could result in a "massive increase in their liabilities," could ultimately limit "the insurance coverage [small insurers] are able to provide for main street businesses."[61]

E. Availability and Cost of Private Reinsurance for Small Insurers

This section considers the availability and cost of private reinsurance for small insurers, in the context of information collected during the 2017 TRIP data call regarding their reinsurance purchases for terrorism risk insurance.

[61] Comments of Property Casualty Insurers Association of America on Small Insurer Study (February 27, 2017) (PCIAA Comments), p. 1, *available at* https://www.regulations.gov/document?D=TREAS-TRIP-2017-0002-0008.

It is difficult to assess the availability and cost of private terrorism risk reinsurance for small insurers for several reasons. Since reinsurance is not a TRIP-eligible line of business, reinsurers are not considered Program participants, and thus are not subject to Treasury's TRIP data calls. Reinsurance is neither subject to standard terms and rates, nor to the range of state-level reporting requirements applicable to admitted insurers. In addition, many factors affect the pricing of reinsurance – such as the reinsurance limits sought and obtained, the price of the underlying risk covered by the reinsurance, the amount of available information concerning that underlying risk, the prior claims history between an insurer and its reinsurers, and general market conditions when the reinsurance is purchased. Furthermore, reinsurance agreements often cover multiple risks, so it can be difficult to isolate and assess how reinsurance specifically responds to terrorism risks.

A small insurer that is concerned about its ability to obtain recovery under the Program for losses above its deductible may attempt to cover this exposure by purchasing reinsurance. For example, a small insurer could purchase reinsurance that provides reimbursement for any losses experienced above the insurer's deductible if an act of terrorism is certified but the Program Trigger is not met by aggregate industry insured losses. Whether purchase of such reinsurance is practical (assuming that it is available) will depend in part upon the cost of the reinsurance and the insurer's assessment of its ability to bear the loss without reinsurance.

Historically, reinsurance markets have been cyclical, and the broader market for reinsurance is currently characterized as "soft," meaning that reinsurance premium rates are relatively low and availability is relatively high.[62] Although a range of macroeconomic factors play a role in the reinsurance market, current conditions are generally viewed as resulting from relatively benign catastrophe losses experienced by reinsurers in recent years, leading to significant traditional reinsurance market capacity, augmented by growing capacity from the capital markets, available to support risk transfer from the primary insurance market.[63]

Treasury found that small insurers tend to transfer, or cede, a greater proportion of their direct premiums to reinsurers than larger insurers. Figure 11 illustrates the portion of premiums of TRIP-eligible lines ceded by direct insurers to reinsurers of small insurers and non-small insurers.

[62] *See generally* "IAIS Global Insurance Market Report (GIMAR) 2016," International Association of Insurance Supervisors (January 31, 2017), p. 3 ("Non-life (re)insurance continues to be subject to soft market conditions. Premiums charged by non-life (re)insurers in the commercial lines, property and catastrophe markets remain under pressure, partly due to increasing competition, while investment yields are declining gradually. Competition is especially strong in the reinsurance market."), *available at* https://www.iaisweb.org/file/64547/2016-global-insurance-market-report.

[63] *See, e.g.*, L. S. Howard, "Is Soft Market Bottoming? A.M. Best Points to Some Promising Signs," Insurance Journal (January 10, 2017), *available at* http://www.insurancejournal.com/news/international/2017/01/10/438420.htm.

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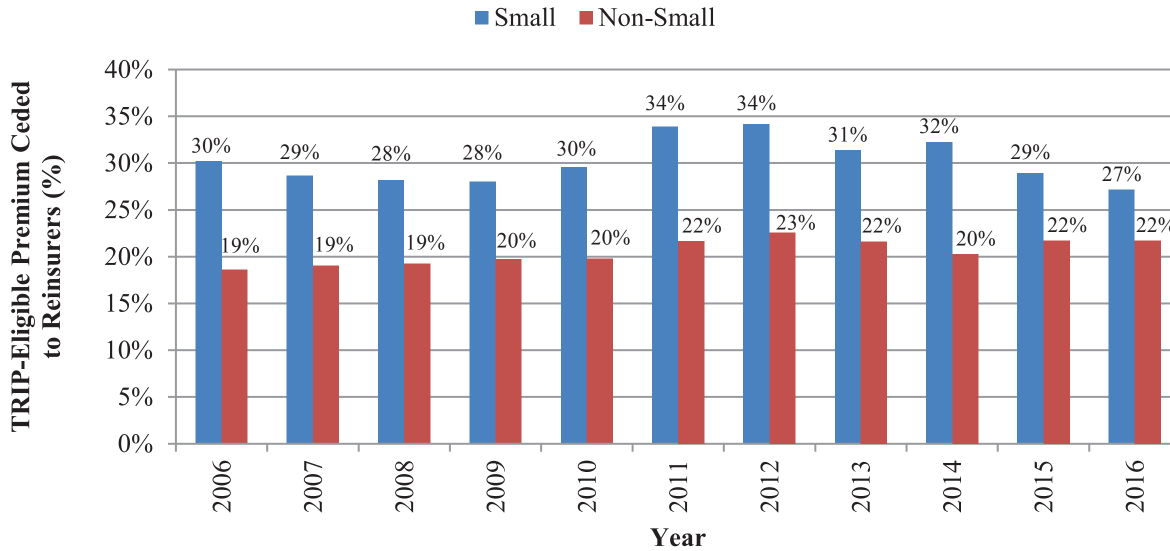
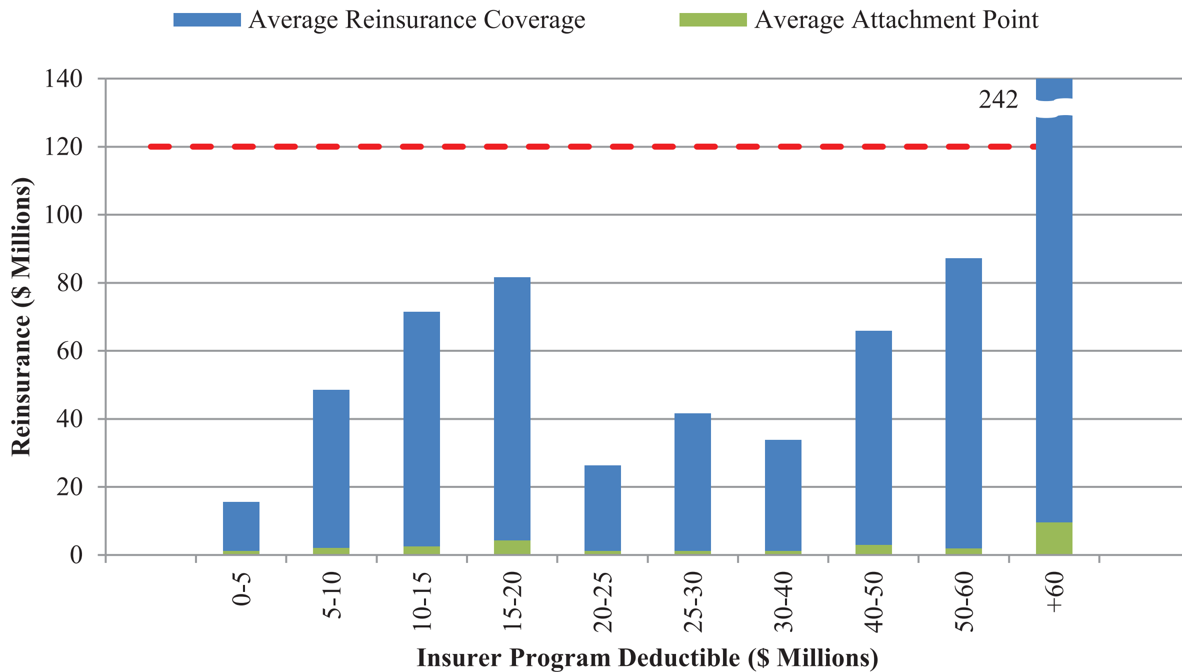
Figure 11: Proportion of TRIP-Eligible Lines Premiums Ceded by Insurers to Reinsurers Small Insurers vs. Non-Small Insurers



Source: SNL Financial

Although the 2017 TRIP data call did not collect data from reinsurers, it did collect certain information from insurers concerning their purchases of reinsurance for terrorism risk. In this Study, Treasury compared the amount of such purchased reinsurance with the Program deductibles of small insurers to assess whether the private reinsurance would cover the possible exposure between the insurer's deductible and the Program Trigger. Figure 12 illustrates the manner in which reinsurance purchases of small insurers provide protection for potential exposures within and above deductibles up to the Program Trigger.

Figure 12: Comparison between Small Insurer Deductibles and Reinsurance Purchases, Illustrating Position between Reinsurance Limit and Program Trigger



Source: 2017 TRIP Data Call

Figure 12 illustrates the extent to which small insurers have obtained reinsurance for losses within their deductibles, as well as for amounts above their deductibles up to the Program Trigger. Based on the 2017 TRIA data, approximately 77 percent of small insurers have obtained reinsurance that may cover some portion of losses exceeding the insurer's TRIP deductible. Therefore, when divided into categories by the size of their Program deductibles (horizontal axis), the 2017 TRIA data illustrates that average reinsurance purchases (vertical axis) are typically in excess, for most size categories, of the Program deductibles. Figure 12 suggests that small insurers generally do not purchase reinsurance from "dollar one" of their exposure. Rather, the reinsurance is generally purchased to apply at some higher loss amount (beginning at the attachment point), below which the small insurer remains exposed to the losses.

Figure 12 also reflects that a large percentage of small insurers face significant exposure between their TRIP deductibles and the Program Trigger which has not been addressed by private reinsurance. This is illustrated by the space in Figure 12 above the blue reinsurance purchase bar and below the red dotted Program Trigger threshold line. Only 11 percent of the reporting small insurers have closed this gap, and most of these small insurers are at the upper limit of the small insurer threshold.

In general terms, and based on the 2017 TRIA data, Treasury finds that small insurers purchase significant amounts of reinsurance for losses up to their deductible obligation under the Program. In contrast, there is less reinsurance protection for losses between an insurer's deductible and the Program Trigger amount. This differential could demonstrate that generally such coverage is not

affordable or readily available.[64] But it could also be based upon an insurer's assessment that it is unlikely to sustain losses up to the Program Trigger, or that it can afford to sustain such losses, or that its portfolio of insured risks is such that in the event of a large loss situation caused by an act of terrorism the losses of unaffiliated insurers could satisfy the Program Trigger. Treasury will consider how to obtain and further analyze appropriate data providing additional information concerning the price and availability of private terrorism risk reinsurance for small insurers. Treasury will continue to analyze this issue and report on the subject in 2019.

F. Impact of State Workers' Compensation Laws

The workers' compensation system provides an important mechanism for the protection of U.S. workers from the consequences of employment-related injuries. To provide that protection, however, certain aspects of the system have the effect of increasing the aggregation exposures of insurers participating in this market to losses from terrorism, possibly presenting solvency issues, particularly because these policies provide coverage for workers' compensation benefits as defined by state law and are not subject to express limits of liability.

State workers' compensation systems provide compensation, on a no-fault basis, for the workplace injuries of employees, including disability and death. The costs of medical care and treatment, rehabilitation, loss of wages, and other financial hardships resulting from the employee's injury are covered.[65] Because payments under workers' compensation policies are limited only by the scope of workers' compensation benefits available under state law to employees entitled to the payment of those benefits, payments under a workers' compensation policy could be essentially unlimited.[66] On the other hand, the ability of insurers to collect sufficient premium to cover potentially unlimited costs is limited. Workers' compensation insurance is subject to specific pricing rules under state law, which may not allow for much pricing flexibility.[67] As a result, a large-scale act of terrorism could create significant aggregation

[64] *See* Remarks to the TRIA Federal Advisory Committee by the Greater New York Mutual Insurance Company (May 31, 2017), p. 5 (noting that while direct insurance rates are regulated, reinsurance rates are not, such that small insurers might not be able to pass along such costs to policyholders which puts small insurers at a competitive disadvantage relative to larger insurers that may not require as much reinsurance), *available at* https://www.treasury.gov/initiatives/fio/acrsm/Documents/Remarks_GNY.pdf.

[65] A summary of the U.S. workers' compensation system is available in the 2016 Effectiveness Report, pp. 21-22.

[66] *See* Michael Dworsky and Lloyd Dixon, "The Impact on Workers' Compensation Insurance Markets of Allowing the Terrorism Risk Insurance Act to Expire," RAND Corporation (2014), pp. 5-6, *available at* https://www.rand.org/content/dam/rand/pubs/research_reports/RR600/RR643/RAND_RR643.pdf.

[67] *See, e.g.*, Submission by the National Council on Compensation Insurance to the Advisory Committee on Risk-Sharing Mechanisms (June 5, 2017) (summarizing the development of terrorism loss costs controlling the premium charge for workers' compensation insurance under state law), *available at* https://www.treasury.gov/initiatives/fio/acrsm/Documents/National_Council_on_Compensation_Insurance_June_2017.pdf.

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risks for workers' compensation carriers, particularly in the event of broad-based losses arising from an NBCR event.[68]

Because insurers cannot decline to cover terrorism risk (including NBCR-related terrorism risk) in connection with workers' compensation insurance, workers' compensation carriers must find other ways to manage their aggregation risk – including by declining certain risks altogether. For example, insurers may avoid writing policies that could provide substantial accumulation of exposures in the same location. This could present challenges for insurers conducting business in large metropolitan areas with dense populations, as well as for employers seeking insurance coverage in those areas.

To the extent a particular policyholder cannot obtain coverage from an insurer in the "voluntary" market, it may need to obtain insurance in the residual market, which must provide coverage to all applicants.[69] Such coverage generally comes with a higher premium. To remain in the worker's compensation market, insurers could use reinsurance to help manage aggregation risks.

The 2017 TRIP data call analyzed whether the reinsurance purchased by insurers to cover losses in TRIP-eligible lines included coverage for NBCR risks associated with workers' compensation insurance. Based on the 2017 TRIP data call, a significant number of small insurers did not have reinsurance coverage for workers' compensation losses caused by NBCR risks. However, the minority of small insurers that did obtain reinsurance coverage for this type of risk were generally able to do so at similar limits compared to their conventional terrorism reinsurance policies. More than 80 percent of small insurers reported that their reinsurance agreements did not cover NBCR risks for workers' compensation. Of the remaining small insurers that obtained reinsurance for this risk, 45 percent were able to obtain the same or higher limits as the limits under their conventional terrorism reinsurance. The remaining 55 percent of insurers obtained this coverage at moderately lower limits than their conventional terrorism risk limits. On average, insurers obtained NBCR limits – in those circumstances in which reinsurance was obtained for NBCR risks – that were approximately 90 percent of their conventional terrorism limits.

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[68] *See, e.g.*, "Terrorism Risk Insurance: Report of the President's Working Group on Financial Markets," (September 2006), pp. 72-73 (noting estimates of modeled NBCR event exposures up to $158 billion in property losses and $484 billion in workers' compensation losses), *available at* http://www.pciaa.net/docs/default-source/default-document-library/pres_wkg_grp_rpt_9-06.pdf; Charles Meade and Roger C. Molander, "Considering the Effects of a Catastrophic Terrorist Attack," RAND Corporation (2006), pp. 6-7 (estimating potential losses arising from explosion of 10-kiloton nuclear bomb in a shipping container as exceeding $1 trillion), *available at* http://www.rand.org/content/dam/rand/pubs/technical_reports/2006/RAND_TR391.pdf.

[69] A residual market exists to provide insurance coverage for those who cannot obtain coverage in the regular, or voluntary, market. Insurers operating in a particular jurisdiction are usually required to participate in residual markets as a condition of doing business in the voluntary market. The extent of their participation in the residual market is generally based upon their share of the voluntary market. Depending upon the jurisdiction, insurance costs in the residual market may be higher, or may effectively be subsidized through assessments on taxpayers or insurers, which may then be passed on to all policyholders in the jurisdiction. *See, e.g.*, PCIAA Comments, p. 2; Atlantic Charter Remarks, p. 8.

In contrast, although a much higher percentage of non-small insurers (approximately 49 percent) held reinsurance coverage for NBCR risks associated with workers' compensation coverage, the limits under this reinsurance were much lower than the limits for conventional terrorism risk (approximately 52 percent on average).

If large workers' compensation losses fall disproportionately upon a small number of participating insurers, TRIP provides a backstop that operates as a risk-spreading mechanism across the industry. In this circumstance, as observed in Treasury's 2016 Effectiveness Report, the Program could be the determining factor in ensuring an insurer's solvency.[70] The Program operates in this fashion irrespective of the size of the insurer participating in the workers' compensation market, but may be more critical for those insurers falling into the "small insurer" category, which may have less policyholder surplus available to face the unpredictable workers' compensation losses that could arise from an act of terrorism.

[70] "TRIA effectively allows insurers to continue to participate in the workers' compensation insurance markets when, in the absence of a government backstop for the terrorism risk, they might be forced from the market altogether." 2016 Effectiveness Report, p. 22, note 69.

V. Conclusion

Small insurers are a significant component of the market for terrorism risk insurance in the United States.

While the market share of small insurers subject to the Program has gradually decreased over the period where the Program Trigger remained constant, this decline is generally consistent with the analysis of market share information for P/C lines of insurance not subject to TRIP. There has also been a decline for small insurers in the premium received and policyholder surplus in TRIP-eligible lines of insurance. Small insurer market share, premium, and policyholder surplus will potentially increase in the future because of the annual increase in the Program Trigger through 2020.

Based on the 2017 TRIP data call, small insurers charge less than non-small insurers for terrorism risk insurance, and are more likely to charge no premium for such coverage. Additionally, the take-up rate for terrorism risk insurance of small insurers' policyholders is lower than the take-up rate of larger insurers' policyholders. Small insurers tend to operate on a regional basis, in fewer states than larger insurers, and their insurance writings are more heavily concentrated than those of larger insurers (such that they have a larger share of the overall market in those lines) in the commercial multi-peril and workers' compensation lines of insurance.

This Study is not making conclusions regarding the impact of the mandatory availability requirement on the market competitiveness of small insurers. Treasury will continue to evaluate whether the mandatory availability requirement is having any market impacts on small insurers in the TRIP-eligible lines of insurance.

The Program Trigger requirement can operate to prevent reimbursement for small insurers that sustain terrorism losses in excess of their Program deductibles. Small insurers may purchase private reinsurance to avoid this potential challenge. The 2017 TRIP data call indicates, however, that most small insurers do not purchase sufficient private reinsurance to address this issue. Although small insurers may otherwise be protected by the existence of losses of other insurers that satisfy the Program Trigger, this will vary from case to case, depending on the size of insured losses arising from the act or acts of terrorism.

Terrorism risk insurance must be provided as a component of workers' compensation insurance under state law. Therefore, this potential risk for small insurers of unreimbursed losses in excess of Program deductibles could be more pronounced in connection with this line of insurance. Small insurers have a larger share of this market, which is subject to potentially unlimited losses and significant aggregation risks.

INFORMED DECISIONS ON CATASTROPHE RISK

Post-Flood Mitigation

The NFIP's *Increased Cost of Compliance (ICC)* Coverage

In connection with the National Flood Insurance Program (NFIP)'s anticipated reauthorization in 2017, Congress is looking at several proposals that would address the program's **Increased Cost of Compliance (ICC)** coverage, expanding its eligible uses and giving policyholders more funds to implement qualifying risk-reduction measures. In this policy brief, we examine ICC claims for single-family homes from 1997 to 2014 and report on our findings from conversations with floodplain managers in several states. Our analysis provides context for ongoing debates in Congress and highlights some of the key reasons the program is not more widely used. We also compare each of the proposals currently under consideration and discuss the implications of proposed reforms.

Increased Cost of Compliance (ICC) **coverage provides funds to NFIP policyholders to bring flood-damaged homes into compliance with current floodplain management regulations.**

Unfortunately, ICC coverage is not well-understood by homeowners and often does not provide enough funds to cover required mitigation expenses.

Proposals in Congress would increase coverage available under ICC and expand its eligible uses, giving policyholders more funds for risk reduction post-flood.

Standardized communication to homeowners immediately after a flood could improve understanding of the program, as could guidance to communities on how to assist policyholders in making effective use of ICC coverage.

- ICC coverage is not widely used. From 1997 to 2014, the NFIP paid 774,000 single-family claims, totaling $30.6 billion. Over the same time period, there were only 27,000 ICC claims for single-family homes, totaling a bit over $700 million (2016 dollars).

- The key trigger for use of ICC funds is a determination that a policyholder's home has been substantially (more than 50%) damaged. It is not surprising then, that the highest payouts of ICC funds were after Hurricanes Katrina and Sandy.

- ICC coverage has some parallels to Law & Ordinance (L&O) insurance, which can be added to standard homeowners policies. L&O coverage pays for the costs of upgrades to meet current regulations when repairing a damaged home. For example, communities might require upgrades to meet plumbing, roofing, or electrical standards when rebuilding.

- Some proposed reforms would treat ICC coverage more like a grant than an insurance product. Rather than muddle these two different policy tools, ICC coverage should be improved to be a useful insurance product for maintaining compliance with updated floodplain regulations. Simultaneously, Congress should expand and reform mitigation grants to better address homeowner needs.

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Introduction

Congress is currently considering reforms to the National Flood Insurance Program (NFIP) during the short-term extension under which the program is now operating. Currently, there are three bills proposed in the Senate (S.1313, S.1368, and S.1571) and a suite of linked bills proposed in the House (H.R. 1422, H.R. 1558, H.R. 2246, H.R. 2565, H.R. 2868, H.R. 2875, and H.R. 2874). All of these reform efforts would make changes to a lesser-known component of the NFIP: Increased Cost of Compliance (ICC) coverage.

When an NFIP-insured home is substantially or repetitively damaged by flooding, the owners are required to upgrade their property to meet the community's current floodplain management regulations. This could mean elevating the home, undertaking flood-proofing activities, or relocating entirely. ICC coverage is designed to help policyholders cover the costs of meeting these requirements.

Created by Congress in 1994, ICC has been a mandatory part of most NFIP policies since 1997. Homeowners pay an additional $4 to $70 for this coverage. ICC coverage is automatically included in new and renewed NFIP policies.[1]

ICC is widely praised because it makes funds available to homeowners faster than federal disaster aid for hazard mitigation, which may take months or years to get into the hands of victims. It is just as widely criticized, however, because the available funds, currently capped at $30,000, do not fully cover the cost for projects such as elevation. In 2016, FEMA's Office of the Flood Insurance Advocate reported that while ICC has been a substantial resource and effective mitigation tool for some policyholders, it has been a source of frustration and confusion for others.

Overview of ICC Coverage

ICC coverage provides up to $30,000 to NFIP policyholders to help cover the costs of bringing a flood-damaged home into compliance with local floodplain management regulations—regulations intended to reduce future flood damages.[2] These include provisions that all new construction, or substantially damaged or improved properties in the 1% annual chance floodplain (known as the Special Flood Hazard Area, or SFHA), be elevated so that the lowest floor is at or above base flood elevation (BFE)—the height of waters in a 100-year flood.

For residential structures, ICC provides funds for three mitigation measures: elevation, relocation, and demolition, or some combination thereof (for non-residential buildings, flood-proofing is also an option). Policyholders file ICC claims separately from regular flood insurance claims; policyholders are currently limited to a combined payout of $250,000 from their standard flood policy and ICC coverage.

By law, the following properties are eligible for ICC payments:

1) Substantially damaged properties (those with flood damage exceeding 50 percent of the building's value);
2) Repetitive loss properties (those that have experienced flood-related damage at least twice in 10 years with the average cost of repairs totaling at least 25 percent of the building's pre-flood value);
3) Properties for which the FEMA Administrator determines ICC is cost effective and in the best interest of the National Flood Insurance Fund; and
4) Properties receiving an offer of mitigation through FEMA's Hazard Mitigation Assistance programs or "any program authorized or for which funds are appropriated to address any unmet needs or for which supplemental funds are made available."

In practice, 99% of ICC claims were for substantially damaged properties, with another 1% for repetitive loss structures and none for the remaining two possible triggers.[3] As we discuss further below, the first category is the one where ICC coverage mimics the building ordinance coverage often offered with homeowners policies to pay for compliance with updated building codes. Use of ICC funds for the other three categories would treat it more like a grant and less like insurance (see discussion below).

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[1] It is not available, however, for contents-only policies, group flood insurance policies, or for policies in emergency program communities (roughly 1% of communities).

[2] When ICC was first implemented in June 1997, coverage was limited to $15,000. In 2000, the limit increased to $20,000, and in 2003, it was raised to $30,000, where it stands today.

[3] See https://www.fema.gov/media-library-data/20130726-1447-20490-5393/increasedcostofcompliancecoverage_2012.pdf

ICC Premium Prices

The ICC premium is calculated based on a number of variables, including whether the building is pre-FIRM (pre-Flood Insurance Rate Map, meaning it was built before flood hazards were mapped and receives a discounted rate on flood insurance), the flood zone, the BFE, the quantity of coverage, and (in certain situations) other structural characteristics of the building. The highest ICC coverage premiums are for pre-FIRM properties in the SFHA since these are the properties most likely to have an ICC claim as they were built before floodplain management regulations were adopted. The lowest premiums are for properties elevated more than two feet above the BFE and those outside the SFHA since, in most cases, these properties would be in compliance with local regulations and thus less likely to have an ICC claim. Table 1 provides an overview of ICC premiums for single-family homes.

Table 1. ICC Premiums for Single Family Homes

			Building Coverage	
	Flood Zone[*]	***Elevation Difference***[**]	***$1 – $230,000***	***$230,001 – $250,000***
Pre-FIRM	A, V	N/A	$70	$55
	X	N/A	$5	$4
Post-FIRM	A	> -2	$5	$4
		< -1 (non-elevated)	$34	$24
		< -1 (elevated)	$9	$6
	V (post-1981)	> -4	$18	$13
	V (1975-1981)	> -2	$30	$20
	X	N/A	$5	$4

[*] The elevation difference, given in feet, refers to the difference in elevation between the lowest floor and the BFE.
[**] The A and V zones depict the 100-year floodplain (SFHA) and the X zone is outside the 100-year floodplain. V zones are subject to breaking waves at a least 3 feet; A zones are not.
Source: *NFIP Flood Insurance Manual*, Effective April 1, 2017

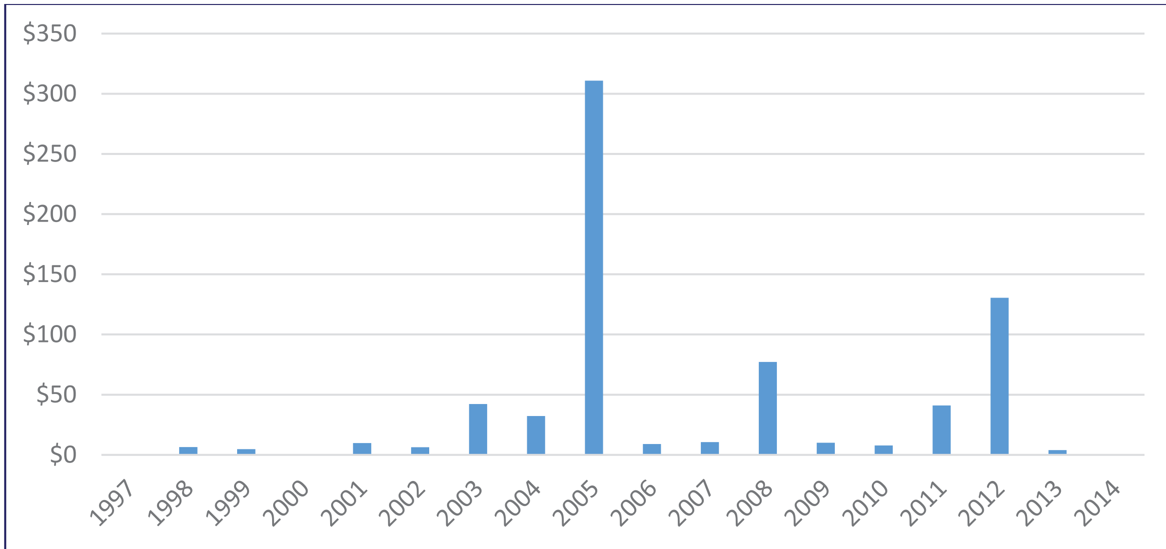
As a mandatory coverage, all policyholders are required to pay the ICC premium. Yet, in general, funds are only available to properties located in the SFHA where floodplain regulations typically apply. However, if buildings outside the SFHA are required to meet higher standards, funds may also be available to these properties. We find that over period of 1997 to 2014, 92 percent of claims are paid to properties inside the SFHA and 8 percent to those outside it. We also find that the percentage of paid NFIP claims that also received ICC funds is nearly four times higher for SFHA properties (4.43 percent as opposed to 1.14 percent). These differences are reflected in the premium table above as X zone properties pay only a nominal rate for ICC coverage.

Findings

From the program's inception in 1997 through 2014, 93 percent of ICC claims were for single-family residences. Several floodplain managers told us that use of ICC coverage can be problematic for multi-family dwellings, such as condos, because the program pays only $30,000 per overall structure, not per condo unit. Given the low use among other building types, the remainder of our analysis focuses only on single-family properties.

Over this period, ICC paid more than 27,000 single-family claims, totaling more than $700 million (in 2016 dollars). The average ICC claim is just over $25,000 (2016 USD). As illustrated in Figure 1 (next page), the program was not widely used initially; ICC spending and claims were highest in 2005 ($311 million; 12,000 claims) and 2012 ($131 million; 4,900 claims). This is not surprising considering that Hurricanes Katrina and Sandy led to many substantially damaged structures in those years, respectively. This also explains why Louisiana ($273 million) and New Jersey ($109 million) are the top two states for use of ICC coverage funds over this period.

Figure 1. Total ICC Claims by Year (millions of 2016 USD)

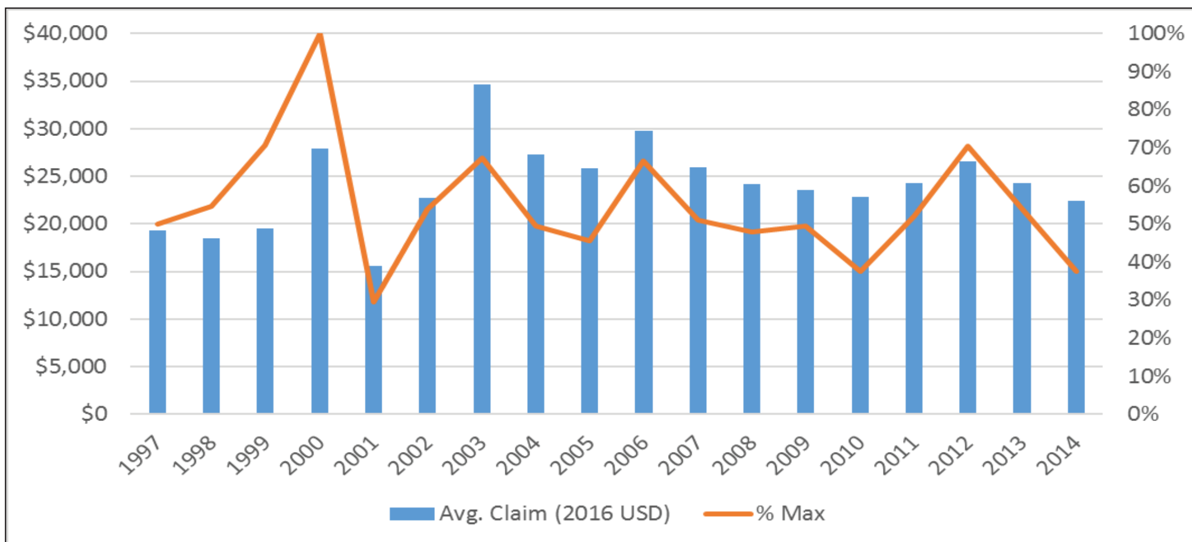


Even in 2005 and 2012, however, the percentage of paid NFIP flood claims that also made use of ICC coverage was small—ranging from less than 1 percent in the early days of the program to a high of only 7.5 percent in 2005. This could be because some properties that flooded did not meet the substantial damage criteria, some were already compliant with regulations, and some policyholders did not file a claim, even if eligible.

The floodplain managers we spoke with highlighted a number of reasons the program has not been more widely used. For example, many homeowners do not know about the program and there is often little outreach to educate them on the procedures on making a claim for ICC coverage—an issue underscored by the Flood Insurance Advocate's annual reports from 2015 and 2016. In addition, the maximum of $30,000 is insufficient to cover the costs of mitigation, particularly measures to elevate properties which can easily be three to five times this amount. Moreover, policyholders with flood damage near the combined payout limit of $250,000, such that their standard flood claim approaches the maximum, are not be able to receive the full amount of ICC funds.

Over the period of our analysis, we find that 52 percent of claims have received the maximum ICC payout. Figure 2 depicts average annual ICC payments and the percentage of claimants receiving the maximum payout in each year (note that these values are adjusted to 2016 dollars and, therefore, may exceed the ICC maximum).

Figure 2. Average Annual ICC Payments and Percentage of Claims Receiving the Maximum Payment (2016 USD)

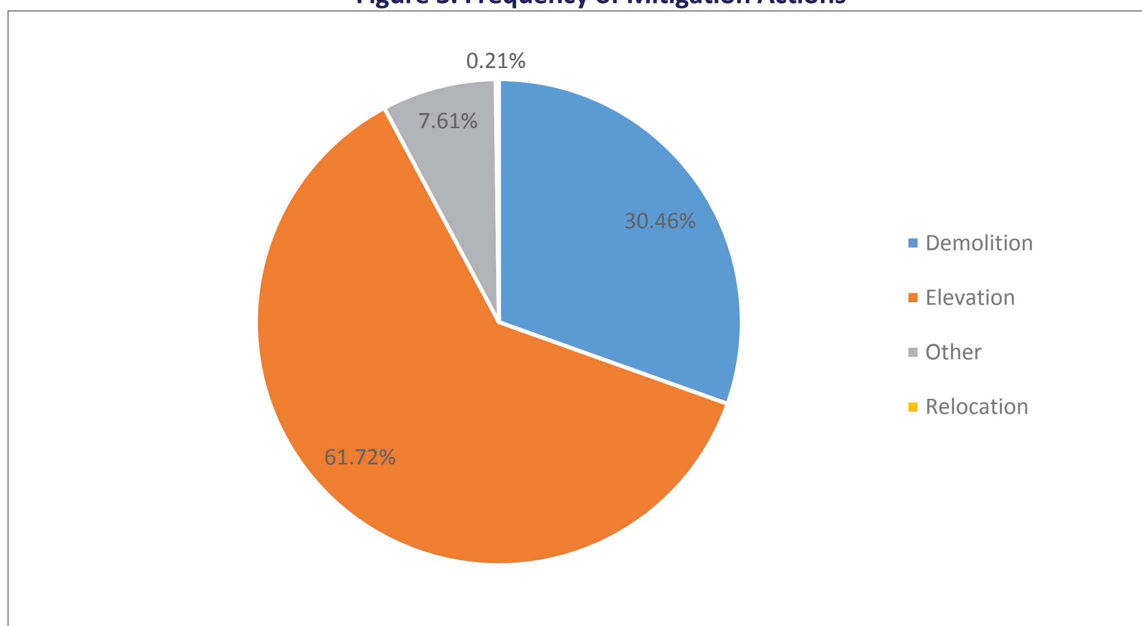


Note: The maximum ICC payout was $15,000 from 1997-1999; $20,000 from 2000-2002; and $30,000 from 2003 to the present

Pre-FIRM properties accounted for 86 percent of those using ICC funds over the period 1997 to 2014. This is intuitive—pre-FIRM properties, since they are older and were built prior to floodplain management regulations, are more likely to be out of compliance when they suffer a loss. In this way, ICC coverage may be a useful tool to help mitigate pre-FIRM properties. This may become increasingly important as pre-FIRM rates are phased out over time according to reforms to the NFIP enacted in 2012 and 2014. Mitigating these properties will reduce their vulnerability to floods and lower their flood insurance premiums.

Single-family homeowners used ICC funds most commonly for elevation (62 percent). Another 30 percent used the money for demolition and less than 1 percent used funds to relocate their homes (See Figure 3). According to some floodplain managers, elevation is the most important cost to cover; others thought that ICC could be usefully expanded to include a broader range of activities, such as buyouts or flood vents, for example. We also heard that it should cover all costs of full demolition, including things like disposal of hazardous building materials.

Figure 3. Frequency of Mitigation Actions



Insurance vs. Grant[4]

The ICC program in its current form poses further challenges because the program encompasses some aspects of an insurance product and some aspects of a grant. We believe this situation makes the ICC less effective than if it were more clearly defined one way or the other and this was clearly communicated to households and all stakeholders.

An insurance product to assist homeowners in gaining compliance with updated floodplain regulations should have three key features: it is paid quickly, it covers the full costs of all upgrades to be compliant with current floodplain regulations, and it is triggered by a flood claim. A grant for risk reduction should have three different key features: it can be used by any property in an at-risk area, it can cover a wide range of hazard mitigation options, and it can be used pre-flood. They are thus complimentary policy tools for increasing hazard mitigation investments.

If ICC were limited to those filing a flood claim to bring their home into compliance with upgraded building structures, it could be treated fully as an insurance product. The language used for this coverage could be similar to that used in homeowners policies and it should cover the full costs of all necessary upgrades. This may increase the cost of ICC coverage, but only nominally as it is already a small addition to the annual premium. It should be available to anyone filing a flood claim and funds should be made available quickly, with some paid before construction begins to ease the financing burden on homeowners.

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[4] This section builds on Carolyn Kousky's July 2017 op-ed in *The Hill*: How to Reform Flood Insurance to Keep More Americans Afloat.

However, certain other policyholders would still need help with hazard mitigation: those who have not suffered a flood loss and those who are not out of compliance with current building codes. These homeowners should be eligible for assistance on mitigation costs, either through grants or low interest loans, or a combination. FEMA already administers several grant programs, but they suffer from two problems. First, it takes too long for dollars to get to those who would make use of them. An expedited process is needed for administering mitigation grants. Second, the vast majority of mitigation dollars are only made available after a disaster declaration and through supplemental funds. More pre-disaster dollars could be targeted at cost-effective investments to reduce risk before a flood occurs.

Proposed Reforms

Currently, proposals in both the House and Senate would reform some aspects of the ICC. We provide a table comparing certain ICC provisions of the four proposals in Appendix A.

All of the proposals would increase the cap above $30,000, as the current limit is usually not enough to cover the cost of elevating many homes. The Senate bills also remove the stipulation that ICC payouts cannot cause total claims payments to rise above the $250,000 residential cap. Both of these are important reforms: if the ICC is truly to be a product to help policyholders come into compliance with current floodplain regulations, it needs to cover the full cost of these upgrades. Increasing the cap would likely necessitate increases in the cost of premiums for ICC coverage. Given the current low premiums, however, any increases would presumably not be substantial. All four proposals now in Congress expand the range of eligible activities. This, too, could be useful if different measures would help homeowners comply with floodplain management codes and lower their risk.

These reforms could widen the use of the ICC for mitigating pre-FIRM and repetitive loss properties after a flood, which in turn could lower overall damages and lead to lower premiums for households, especially if they elevate above BFE. Since pre-FIRM premiums are increasing over time, mitigation would lower the price these homeowners have to pay as they could then be rated post-FIRM and fully compliant with current building codes.

None of the bills, however, addresses concerns about a lack of knowledge of the program. Standardized communication to homeowners immediately after a flood may help, as could FEMA outreach to communities with guidance on how to help them aid policyholders in making effective use of ICC coverage. Updating the coverage to more closely match building codes may improve understanding by insurance agents and this may in turn make it easier to communicate to policyholders.

Limiting ICC to be a true insurance product, however, should be coupled with increased funding for mitigation grants to help other homeowners reduce their flood risk and mitigate their properties. Three proposals currently in Congress do indeed increase grant funding for pre-disaster mitigation, and one targets this at the riskiest properties. Coupled to strategies to improve timeliness, these would help more families lower their risk.

Appendix A: 2017 ICC Reform Proposals (as of August 2017)

	S. 1313 (Cassidy-Gillibrand)	S. 1368 (SAFE NFIP Act)	S. 1571 (Crapo-Brown)	H.R. 2875 (House Financial Services)
Expanded Coverage	• Increases primary coverage to $75,000	• Increases primary coverage to $100,000	• Increases primary coverage to $60,000 • Provides optional coverage up to $100,000	• Maintains primary coverage maximum at $30,000 • Provides optional coverage up to $60,000
Effect on NFIP Payout Limits	• Up to 50% of ICC payments may exceed the maximum payout limit • Raises residential building coverage limits to $500,000	• Exempts ICC payments from maximum payout limits • Raises residential building coverage limits to $500,000	• Exempts ICC payments from maximum payout limits	• No changes
Expanded Eligible Activities	• Any activity under FEMA's Pre-Disaster Mitigation program	• Acquisition/demolition, elevation, and/or relocation projects allowed under NFIP and FEMA's Hazard Mitigation Assistance programs • Includes costs of ramps, elevators, or other devices a homeowner/occupant needs to access an elevated home due to physical limitations or disabilities	• Acquisition/demolition, elevation, and/or relocation projects allowed under NFIP and FEMA's Hazard Mitigation Assistance programs • Includes costs of ramps, elevators, or other devices a homeowner/occupant needs to access an elevated home due to physical limitations or disabilities	• Certain pre-disaster mitigation costs for certain at-risk properties identified by state and local governments
ICC Requirements for Private Flood Insurance Policies	• Private flood policies are required to provide law and ordinance coverage that meets or exceeds NFIP ICC coverage • Requires private insurers to impose and collect an ICC surcharge on private flood policies; proceeds are deposited in the NFIP's National Flood Insurance Fund	• No provisions	• No provisions	• No provisions

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Issue Brief: Post-Flood Mitigation: The NFIP's *Increased Cost of Compliance (ICC)* Coverage

INFORMED DECISIONS ON CATASTROPHE RISKS issue briefs are published by the Wharton Risk Management and Decision Processes Center of the University of Pennsylvania. For additional information, contact Carol Heller, hellerc@wharton.upenn.edu or 215-898-5688.
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Micro-captive Arrangement Deemed Not to Be Insurance; Taxpayer Loses in Avrahami Case

By Carrie Small

In the first section 831(b) case to make it to trial, the U.S. Tax Court backed the Internal Revenue Service (IRS) by holding that a micro-captive's elections under section 831(b) to be treated as a small insurance company and section 953(d) to be taxed as a domestic corporation were invalid. The Court also ruled that amounts paid to the captive insurance company did not qualify as insurance premiums for federal income tax purposes and therefore were not deductible under section 162.

The Court held that the micro-captive and risk-pooling arrangement did not meet the definition of insurance and thereby could not be respected as such.

Background

The Petitioners in Avrahami v. Commissioner, 149 T.C. No. 7, Benyamin and Orna Avrahami, owned three shopping centers and three jewelry stores. In 2007, they formed a captive insurance company, Feedback Insurance Company, Ltd. (Feedback), with the assistance of Celia Clark, an attorney that specialized in the formation and maintenance of such insurance companies. Feedback insured certain risks of the Avrahamis' business ventures, including business income, employee fidelity, litigation expense, loss of key employee and tax indemnity coverages. Clark hired Allen Rosenbach, an actuary, to price the various Feedback policies. Each year, Rosenbach was given a "target premium" to meet for the direct policies written by Feedback. This target was to get the total premiums written as close to the $1.2 million limitation as possible to qualify as a small insurance company under section 831(b).

Despite the formation of the captive insurance company, each of the entities owned by the Avrahamis continued to buy insurance from third-party commercial carriers and made no change to the coverage under those policies even after purchasing additional insurance from Feedback.

In addition to the direct coverages provided to the Avrahamis, in 2009 and 2010, Feedback started participating in a risk-distribution pool through Pan American Reinsurance Company, Ltd. (Pan American) to reinsure terrorism insurance for other small captive insurers. Pan American was intended to connect Clark's clients with other businesses that operate small insurance companies so they could distribute risk. Pan American would sell policies to participating businesses and then reinsure all of the risk through the participating insurance companies pursuant to a Terrorism Risk Quota Share Reinsurance Agreement. The businesses would pay premiums to Pan American for terrorism coverage, and then Pan American would take that amount and pay it to the corresponding insurance company in the form of reinsurance premiums.

In 2007, prior to the formation of Feedback, approximately $150,000 was spent insuring the Avrahamis' businesses. In 2009 and 2010, the insurance premiums increased to approximately $1.1 million and $1.3 million, respectively. From Feedback's inception in 2007 to the end of 2010, Feedback had received premiums totaling almost $3.9 million, but had paid no claims.

IRS and Court holdings

The IRS took the position that Feedback was not providing insurance, thereby the premiums paid to the captive insurance company would not be deductible as ordinary and necessary business expenses. The Commissioner argued that several of the micro-captive's policies included uninsurable risks, and there was not adequate risk distribution due to an insufficient pool of insureds. The Commissioner also held that risk was not shifted as neither Feedback nor Pan American was financially capable of meeting its obligations. Lastly, the arrangements did not embody common notions of insurance because Feedback and Pan American did not operate like insurance companies and their premiums were not determined at arm's length.

Judge Mark Holmes confirmed that amounts paid to Feedback and Pan American are not deductible under section 162 and Feedback's section 831(b) and section 953(d) elections are invalid for 2009 and 2010.

The Court held that there was no true risk distribution as Feedback insured only three of the Avrahamis' entities in 2009 and four in 2010. This was too few entities, as well as too few risk exposures, to meet adequate risk distribution as supported by case law. The Court also concluded that the arrangement under Feedback did not meet common notions of insurance because claims were dealt with on an "ad hoc" basis, investment decisions were made that "only an unthinking insurance company would make" and unreasonable premiums were charged.

Regarding Pan American, the Court concluded that it was not a bona fide insurance company and the overall effect of the arrangement was a circular flow of funds. Also, unreasonable premiums were charged for the terrorism insurance, and the probability of a claim actually being triggered was extremely low based on how the coverage was written.

Increased scrutiny on micro-captive arrangements

While the negative facts highlighted by the court are specific to this case in and of itself, it still serves as an important reminder for taxpayers to revisit the structures of their micro-captives. The IRS has applied increased scrutiny to micro-captives, most recently including the structures on the "Dirty Dozen" list of tax scams in 2015, and also listing them as a transaction of interest in 2016. The concern is that micro-captives are being formed to create a deduction for the related-party owner for the insurance premiums paid,

while the micro-captive only pays tax on its investment income under section 831(b). The micro-captive then builds up a surplus from the annual premium income while paying few, if any, claims.

Micro-captives that do not have similar facts to Avrahami, and are acting as a bona fide insurance company, are paying claims, have actuarial determined premiums and are financially capable of meeting its obligations, should continue to withstand IRS scrutiny.

What constitutes insurance?

The Tax Court ultimately ruled that the micro-captive arrangement in Feedback, as well as the risk-pooling arrangement in Pan American, did not constitute insurance. While there is no true definition of insurance in either the Internal Revenue Code or regulations, taxpayers are guided by case law in determining whether insurance exists for federal income tax purposes. To be considered insurance, an arrangement must:

- Involve risk-shifting
- Involve risk-distribution
- Involve insurance risk
- Meet commonly accepted notions of insurance

Other factors that are also considered include:

- Is the company organized, operated, and regulated as an insurance company?
- Is the insurer adequately capitalized?
- Are policies valid and binding?
- Are premiums reasonable and the result of an arm's length transaction?
- Are claims paid?

Generally, the micro-captive should operate as a separate risk-bearing enterprise and function no differently than a third-party insurer.

Impact of this ruling on micro-captives

There can be a significant tax consequence for micro-captives that fall under a fact pattern similar to that presented in Avrahami. The tax benefit of qualifying as a small insurance company under section 831(b) is that the captive is taxed on investment income only, and therefore not on underwriting, or premium, income. An insurance company is generally considered to be a small insurance company when premiums are less than $1.2 million (note this limitation has been increased to $2.2 million starting in 2017 to adjust for inflation). If the captive does not fall under this limitation, underwriting income becomes taxable. However, even more importantly, the

company must first be an insurance company. In the case of Feedback, it was determined that the arrangement did not constitute insurance. Therefore, the premiums paid to Feedback were not considered payments for insurance, and were not deductible for the Avrahamis' business entities under section 162.

In addition to ensuring that micro-captive arrangements meet the definition of insurance as discussed above, the determination of premium pricing should also be reevaluated to ensure the use of actuarial assumptions that represent the current market and the validity of the assumptions used as compared to those used by other actuaries.

Lastly, taxpayers involved in a risk-pooling arrangement should ensure the fronting company has a valid business purpose, operates as an insurance company, and is not formed merely as a mechanism to meet risk-distribution requirements. A circular flow of funds similar to the arrangement under Pan American may be a cause of concern as to whether or not there is true risk shifting and risk distribution.

We recommend organizations contact their tax and captive advisor to review their specific situation for potential issues.

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