Terrorism Risk Insurance Act

Shifting Risk through Terrorism Insurance Captives

Terrorism Insurance Captives

Executive Summary

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Several hundred of the world's largest corporations have set up their own personal insurance companies (captives) engineered to extract hundreds of millions and even billions of dollars in terrorism reinsurance from the federal government. Ultimately, the cost of this corporate shortcut to TRIA's backstop falls on the shoulders of small businesses, churches, school districts and other commercial insurance consumers.

Highly profitable global corporations set up captive insurance companies in amendable jurisdictions to provide their corporate parents with generous terrorism coverages at low cost.

Treasury is required to reimburse 80% of a captive's terrorism losses above a small deductible.

Treasury recovers 140% of backstop payments through surcharges on all commercial policyholders.

Congress Raised Concerns

From the earliest days of TRIA, Congress voiced concern that large corporations could game the backstop through captives. Indeed, the original enactment included authority for Treasury to issue special rules for captives if Treasury found it appropriate to do so.

Concerns about terrorism insurance written through captives were raised in Congressional hearings in 2002 and 2004 and by the President's Working Group on Financial Markets in 2006.

Treasury Abandoned Proactive Scrutiny

Through 2003 and 2004 Treasury issued a series of strong warnings to large corporations not to set up captives in order to unfairly tap into the backstop .

By 2006 Treasury publicly abandoned proactive oversight of captives instead deferring any scrutiny until after there had been a terrorism attack. Terrorism captives proliferated in response.

Although state insurance commissioners have an enforcement role under TRIA, almost all captive-friendly states forbid their commissioners from releasing information on captives even to Treasury.

A Time for Transparency

When the law puts someone's hand in your pocket that law should at least give you the right to know who and for how much. Hundreds of large corporates have secretly outstretched their hands for tens of billions of dollars currently in the pockets of small businesses, churches, school districts and other commercial insurance policyholders.

If Treasury does not wish to pass judgment on terrorism captives, then it should empower the people who will be picking up the tab with the information to do so.

Terrorism Insurance Captives

Mechanics of TRIA's Backstop

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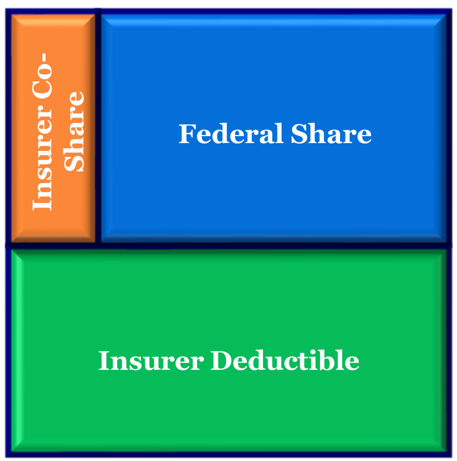
The **backstop** reimburses 80% of insured losses paid by a participating insurer that has met its individual **insurer deductible** for the relevant calendar year. The total of all the individual insurer deductibles is about $41 billion. To put that amount into perspective, insured losses from the terrorist attacks on September 11, 2001 totaled about $47 billion (in 2019 dollars).

The Backstop

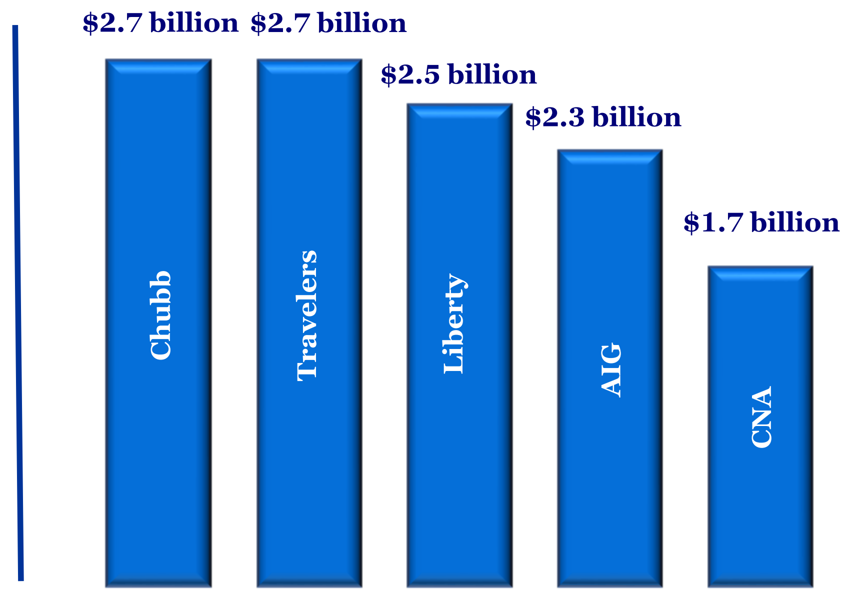
Through the **federal share** Treasury reimburses 80% of an insurance company's terrorism insurance claims after the insurer has satisfied its insurer deductible.

The **insurer co-share** leaves 20% of the cost of terrorism insurance claims above the insurer deductible as the responsibility of the insurer.

The **insurer deductible** is equal to 20% of the insurer's prior year direct earned premium for commercial property and casualty insurance.



5 Largest Insurer Deductibles (2019)



Source for approximate deductible computation: NAIC 2018 Market Share Reports

While we often refer to "the backstop" there are really hundreds of backstops – one for each insurer or insurer group. Large diversified insurers can have individual backstop deductibles approaching $3 billion. In contrast, terrorism insurance captives can engineer insurer deductibles of $1 million or even less. These secret schemes shift billions in risk from some of the largest and most successful international corporations onto the backs of US small businesses, churches, school districts and other commercial policyholders.

Terrorism Insurance Captives

Policyholder Surcharges Fund the Backstop

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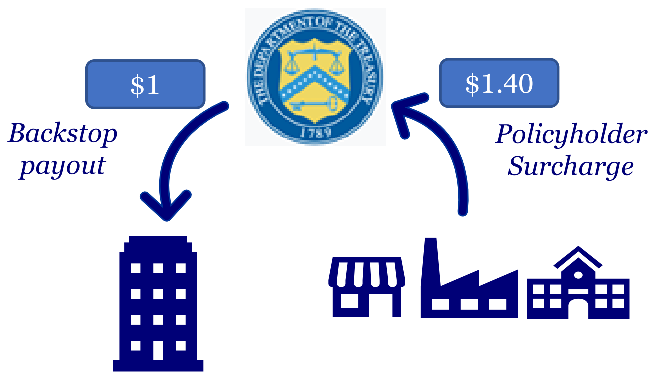
Following a terrorism attack, Treasury levies policyholder surcharges on all commercial property and casualty insurance premium (not just terrorism insurance premium) equal to 140% of backstop payouts. Treasury has the authority to waive some amount of those surcharges for terrorist attacks larger in scale than September 11. This paper assumes Treasury would be bound to impose the 140% mandatory surcharge.

Mandatory and Discretionary Surcharges

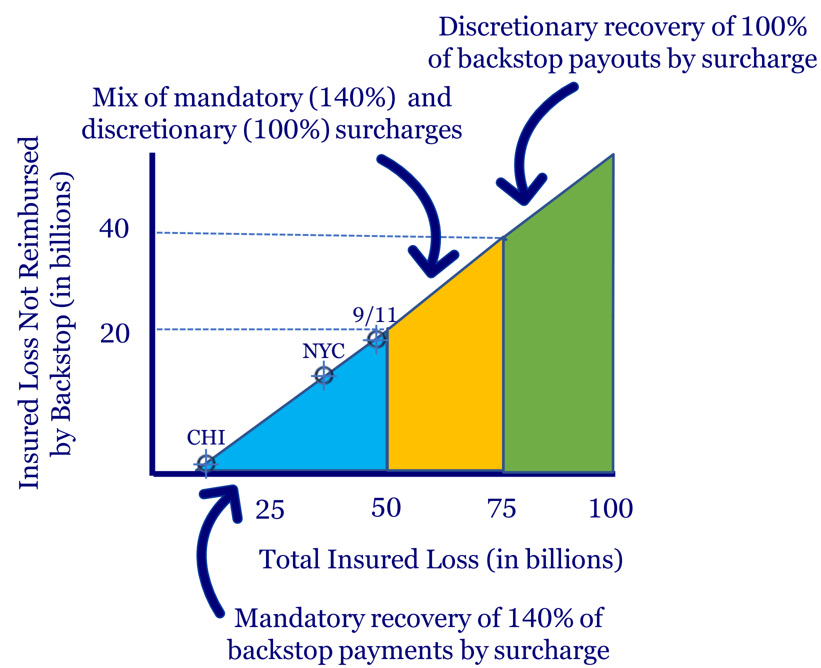
To the extent the total amount insurers pay in unreimbursed insured losses is less than $40,878,630,900 (as adjusted annually), Treasury must impose policyholder surcharges equal to 140% of backstop payouts. Treasury has the discretion to collect up to 100% of any additional backstop payouts.



Except in the most extreme situations, Treasury must collect $1.40 from commercial policyholders for every $1 it pays out of the backstop. The 40% markup originates with Congressional Pay-As-You-Go rules which enforce budget neutrality.

Surcharge Trigger Points

These approximate surcharge trigger points are extrapolated from modeled terrorist attacks in Chicago (2017) and New York City (2016) as reported by Treasury.



Terrorism Insurance Captives

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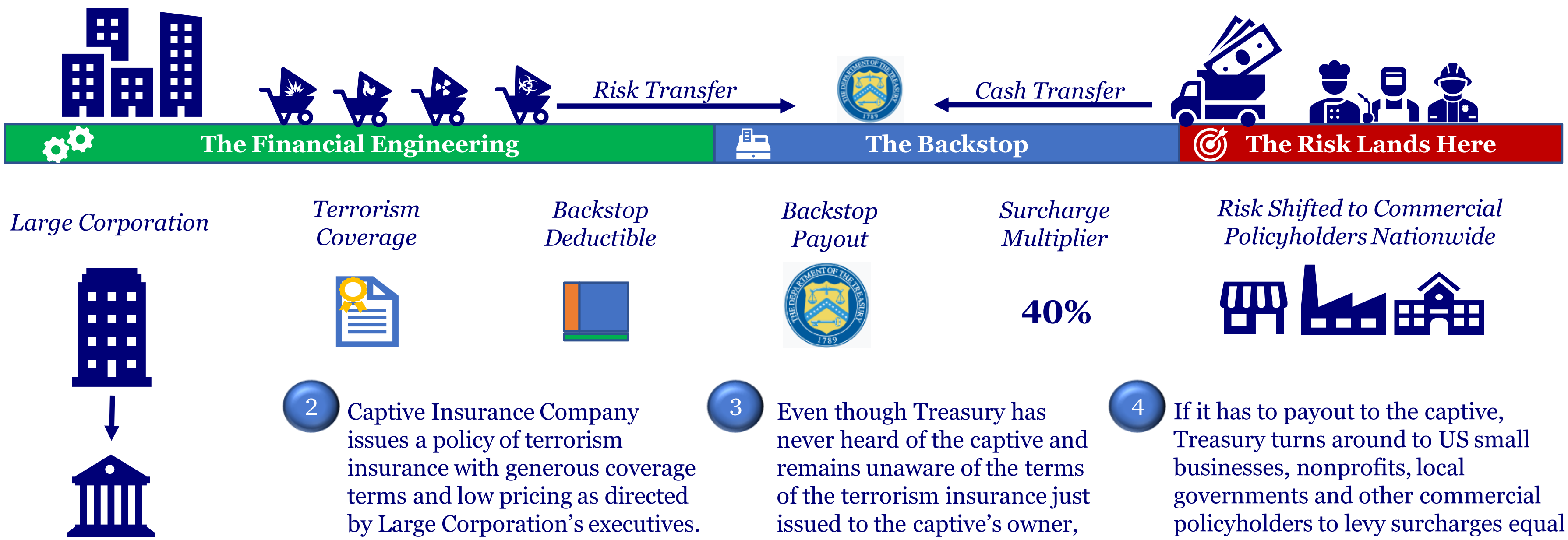
4 Easy Steps to Shift Risk from Mega Corporates to US Small Businesses



1. Large Corporation establishes its own private insurance company in an amenable US jurisdiction. Large Corporation appoints Captive Insurance Company's Board of Directors (usually senior executives of Large Corporation) and a captive manager (usually Large Corporation's insurance broker).

2. Captive Insurance Company issues a policy of terrorism insurance with generous coverage terms and low pricing as directed by Large Corporation's executives.

3. Even though Treasury has never heard of the captive and remains unaware of the terms of the terrorism insurance just issued to the captive's owner, Treasury is immediately bound to reimburse 80% of losses under that insurance policy subject to a small deductible equal to 20% of the captive's annual premium.

4. If it has to payout to the captive, Treasury turns around to US small businesses, nonprofits, local governments and other commercial policyholders to levy surcharges equal to its payments to the captive plus an extra 40%.

Using US Treasury as an intermediary, a large US or foreign corporation can create a captive insurance company that shifts hundreds of millions (and often billions) of dollars in terrorism risk onto the backs of small businesses, school districts, churches and other purchasers of commercial property and liability insurance – even those that have never purchased terrorism insurance. To make matters worse for these consumers, in almost all cases Treasury must mark up its backstop payouts by an additional 40% in setting the policyholder surcharge rate.

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A Swiss Banking Giant Eliminated $1.2B of its Own Risk by Creating $1.7B of Risk for US Small Businesses, Churches, School Districts and Others

Credit Suisse

$1.2 billion terrorism risk →

← ***$1.7 billion surcharge risk***

The Financial Engineering | **The Backstop** | **The Risk Lands Here**

Corporate Parent

Credit Suisse

↓

Terminus Insurance, Inc.

Terrorism Coverage

Backstop Deductible

Backstop Payout

Surcharge Multiplier

40%

Risk Shifted to Commercial Policyholders Nationwide

2. Terminus issued Credit Suisse a portfolio of insurance including a property terrorism insurance policy with $1.5 billion limits (covering conventional and nuclear, biological, chemical and radiological attacks). It appears Terminus earns about $5 million per year in premium.

3. Terminus' low premium income means its backstop deductible is only about $1 million. Therefore, Treasury is on the hook for up to $1.2 billion of Credit Suisse's terrorism losses (80% of $1,499,000,000).

4. If Credit Suisse ever suffers a terrorism loss covered by TRIA, Treasury would recover its payouts to Terminus plus an additional 40% through policyholder surcharges on all commercial property and casualty insurance consumers. Surcharges attributable to Credit Suisse could be as much as $1,678,000,000.

1. In September 2008, Credit Suisse (USA), Inc. formed Terminus Insurance Company in New York. Credit Suisse capitalized its new insurance company with $250,000, appointed Aon as the captive manager and elected three Credit Suisse executives to the new insurance company's Board of Directors.

Credit Suisse reported 2019 profits of $3.4 billion.

As this example illustrates, captives can be used to shift enormous amounts of terrorism risk into the backstop subject to a very small deductible. In the Credit Suisse example, the backstop deductible is only 0.06% of the terrorism insurance coverage limits issued by its captive. Credit Suisse is hardly alone in taking advantage of TRIA backstop and shifting risk onto US businesses.

Terrorism Insurance Captives

Financial Services Companies

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The corporate parent forms its own insurance company and then agrees with its captive on the terms and pricing for terrorism insurance.

Treasury is committed to pay 80% of the captive's insured terrorism losses above its deductible.

Treasury marks up its loss by 40% and sends the bill to all commercial policyholders via surcharge.

The Financial Engineering			The Backstop				The Risk Lands Here
Corporate Parent	*Terrorism Coverage Limits*	*Backstop Deductible*	*Backstop Payout Risk*		*Surcharge Multiplier* 40%		*Risk Shifted to Commercial Policyholders Nationwide*
Credit Suisse	$1.5 billion	$1 million	$1.2 billion	+	$500 million	=	**$1.7 billion**
Barclays	$2.1 billion	$750,000	$1.7 billion	+	$686 million	=	**$2.4 billion**
BNY Mellon	$800 million	$20 million	$624 million	+	$249 million	=	**$873 million**
Moody's	$500 million	$16 million	$387 million	+	$155 million	=	**$542 million**
NYSE	$900 million	$400,000	$720 million	+	$280 million	=	**$1.0 billion**

Sources:

1. *New York Department of Financial Services Report on Examination of Terminus Insurance, Inc. (September 9, 2015).*
2. *New York Department of Financial Services Report on Examination of Barclays Insurance US, Inc. (February 5, 2016).*
3. *New York Department of Financial Services Report on Examination of The Hamilton Insurance Corp. (November 30, 2015).*
4. *New York Department of Financial Services Report on Examination of Moody's Assurance Company, Inc. (May 17, 2013).*
5. *New York Department of Financial Services Report on Examination of Wall and Broad Ins. Co. (April 26, 2016).*

Terrorism Insurance Captives

Media Companies

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The corporate parent forms its own insurance company and then agrees with its captive on the terms and pricing for terrorism insurance.

Treasury is committed to pay 80% of the captive's insured terrorism losses above its deductible.

Treasury marks up its loss by 40% and sends the bill to all commercial policyholders via surcharge.

The Financial Engineering			The Backstop				The Risk Lands Here
Corporate Parent	*Terrorism Coverage Limits*	*Backstop Deductible*	*Backstop Payout Risk*		*Surcharge Multiplier*		*Risk Shifted to Commercial Policyholders Nationwide*
					40%		
21st Century Fox	$1 billion	$33 million	$773 million	+	$307 million	=	**$1.08 billion**
CBS	$1.5 billion	$1.1 million	$1.2 billion	+	$480 million	=	**$1.68 billion**
Publicis Groupe	$350 million	$10 million	$272 million	+	$109 million	=	**$381 million**
Omnicom Group	$200 million	$28 million	$137 million	+	$55 million	=	**$192 million**
The New York Times	$1.2 billion	$9 million	$953 million	+	$380 million	=	**$1.3 billion**

Sources:

1. *New York Department of Financial Services Report on Examination of 21CF Insurance (April 27, 2015).*
2. *New York Department of Financial Services Report on Examination of Blackrock Insurance Corp. (June 23, 2017).*
3. *New York Department of Financial Services Report on Examination of DMB&B Insurance, Inc. (January 3, 2014).*
4. *New York Department of Financial Services Report on Examination of Havershine Insurance Co. (December 12, 2014).*
5. *New York Department of Financial Services Report on Examination of Midtown Insurance Company (April 25, 2014).*

Terrorism Insurance Captives

Real Estate Companies

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The corporate parent forms its own insurance company and then agrees with its captive on the terms and pricing for terrorism insurance.

Treasury is committed to pay 80% of the captive's insured terrorism losses above its deductible.

Treasury marks up its loss by 40% and sends the bill to all commercial policyholders via surcharge.

The Financial Engineering			**The Backstop**				**The Risk Lands Here**
Corporate Parent	*Terrorism Coverage Limits*	*Backstop Deductible*	*Backstop Payout Risk*		*Surcharge Multiplier*		*Risk Shifted to Commercial Policyholders Nationwide*
					40%		
Silverstein Properties	$3.6 billion	$1 million	$2.9 billion	+	$1.1 billion	=	**$4.0 billion**
Vornado Realty Trust	$4.0 billion	$1.5 million	$3.2 billion	+	$1.3 billion	=	**$4.5 billion**
SL Green Realty Corp.	$750 million	$1.3 million	$599 million	+	$240 million	=	**$839 million**
Tishman Speyer	$2.0 billion	$534,000	$1.6 billion	+	$640 million	=	**$2.2 billion**
The Durst Organization Inc.	$1.5 billion	$1.6 million	$1.2 billion	+	$500 million	=	**$1.7 billion**

Sources:

1. *New York Department of Financial Services Report on Examination of Greenwich Street Insurance Company, Inc. (April 5, 2017).*
2. *Vornado Realty Trust 10-Q (September 30, 2019).*
3. *New York Department of Financial Services Report on Examination of Belmont Insurance Company (September 11, 2013).*
4. *New York Department of Financial Services Report on Examination of Inwood Insurance Co., Inc. (April 26, 2018).*
5. *New York Department of Financial Services Report on Examination of Seymour Insurance Co. (August 14, 2013).*

Terrorism Insurance Captives

Other Industries

The corporate parent forms its own insurance company and then agrees with its captive on the terms and pricing for terrorism insurance.

Treasury is committed to pay 80% of the captive's insured terrorism losses above its deductible.

Treasury marks up its loss by 40% and sends the bill to all commercial policyholders via surcharge.

The Financial Engineering			The Backstop			The Risk Lands Here
Corporate Parent	*Terrorism Coverage Limits*	*Backstop Deductible*	*Backstop Payout Risk*	*Surcharge Multiplier*		*Risk Shifted to Commercial Policyholders Nationwide*
				40%		
BROADCOM	$750 million	$235,000	$600 million +	$240 million	=	**$840 million**
PORTS AMERICA	$200 million	$4.4 million	$156 million +	$62 million	=	**$219 million**
TIFFANY & CO.	$778 million	$7.4 million	$621 million +	$248 million	=	**$869 million**
THE MADISON SQUARE GARDEN COMPANY	$1.8 billion	$7.3 million	$1.4 billion +	$600 million	=	**$2.0 billion**
MTA	$1.1 billion	$18 million	$865 billion +	$346 million	=	**$1.2 billion**

Sources:
1. *New York Department of Financial Services Report on Examination of Premier Management Insurance, Inc. (December 3, 2018).*
2. *New York Department of Financial Services Report on Examination of Ports Insurance Company (May 29, 2009).*
3. *New York Department of Financial Services Report on Examination of LCT Insurance Co. (June 17, 2016).*
4. *New York Department of Financial Services Report on Examination of Eden Insurance Co. Inc. (November 4, 2016).*
5. *New York Department of Financial Services Report on Examination of First Mutual Transportation Assurance Company (April 14, 2017).*

Terrorism Insurance Captives

Efficient for the Mega Corporates, Inefficient for US Small Businesses

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Modeled loss scenarios designed by Treasury demonstrate that captives are highly efficient in shifting risk away from the mega corporates that own them but highly costly for everyone else. TRIA allows a captive to reduce each dollar of its corporate owner's terrorism losses to as little as 20¢ while turning that same dollar into more than $1.10 in surcharges imposed on US small businesses, churches, school districts and other consumers of commercial property and casualty insurance.

Modeled Loss Scenario	*Insured Losses*	*Backstop Payout*	*Percent of Total Loss*	*Surcharge Multiplier* 40%	*Loss Shifted to Commercial Policyholders Nationwide*	*Percent of Total Loss*
New York City Truck Bomb						
Traditional Insurers	$29 billion	$12 billion	41%	$5 billion	$17 billion	59%
Captive Insurers	$7 billion	$6 billion	**86%**	$2 billion	$8 billion	**114%**
Total	$36 billion	$18 billion	50%	$7 billion	$25 billion	69%
Chicago Truck Bomb						
Traditional Insurers	$7.5 billion	$0.1 billion	1%	$400 million	$1.4 billion	19%
Captive Insurers	$2.5 billion	$2 billion	**80%**	$800 million	$2.8 billion	**112%**
Total	$10 billion	$2.1 billion	21%	$1.2 billion	$4.2 billion	42%

Source: US Treasury, Report on the Effectiveness of the Terrorism Risk Insurance Program (June 2018).

Terrorism Insurance Captives

Treasury Backed Down on its Warnings and Opened the Floodgates

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In February 2003, Treasury solicited comments whether it should develop regulations to "prevent participation in the Program by newly formed insurance companies deemed by Treasury to be established for the purpose of evading the insurer deductible requirements." Specifically, Treasury raised concerns with "special purpose entities formed to provide terrorism risk only coverage." 68 FR 9815.

Treasury decided not to develop such regulations "but we will continue to monitor developments in the market for terrorism risk insurance and the market's response to the Act." 68 FR 41263.

Treasury Sternly Warns Big Corporates . . .

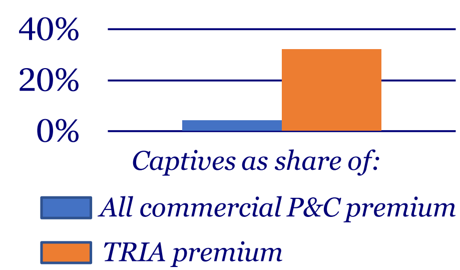
In a series of interpretive letters in 2004 Treasury continued to voice its concern with certain captive structures:

- "The post-enactment formation or utilization of a captive insurer that will only provide stand-alone, single-risk TRIA-only coverage for losses from acts of terrorism raises questions regarding the integrity of the Program." (March 2, 2004)
- "Treasury has concerns about the strategic use of captives as a means of avoiding the requirements of the Act and its implementing regulations." (September 21, 2004)
- "We have concerns about the possibility that captives may be used as a tool for avoiding the requirements of the Act and implementing regulations, particularly where the Act's deductible and mandatory recoupment provisions are involved." (September 24, 2004)

Then Punts

Two years later Treasury backed down by declaring any "determination . . . whether any captive program . . . circumvents the purposes of the Act and Treasury's regulations, will be made at time of the presentment of Captive's claim for federal compensation for any insured losses it may incur, and not before." (October 19, 2006)

2017 Captive Insurer Market Share



- Captives make up only 4% of commercial property and casualty insurance but represent 32% of the US terrorism insurance market.
- 337 terrorism-only captive policies now make up 24% of the entire US terrorism insurance market

With Treasury standing down, the creation of TRIA eligible captives took off. According to Treasury, 517 captives participated in TRIA as of 2016 growing to 575 in 2018. Treasury admits it "does not have a comprehensive U.S. captive count" suggesting there may be more. 65% of the captives Treasury does know about issue terrorism-only insurance policies. *Source: Report on the Effectiveness of the Terrorism Risk Insurance Program, US Treasury (June 2018).*

Terrorism Insurance Captives

Treasury has Authority to Take Control of TRIA and Create Transparency

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Congress expects Treasury to run an efficient and fair program for all stakeholders and gave it the power to do so in Section 104(a):

> The Secretary shall have the powers and authorities necessary to carry out the Program, including authority . . . to prescribe regulations and procedures to effectively administer and implement the Program, and to ensure that all insurers and self-insured entities that participate in the Program are treated comparably under the Program.

It is Commercially Unreasonable Not to Maintain a Register of Participating Insurers

Treasury manages a $100 billion reinsurance program but does not keep a list of insurers ceding risk into that program. Indeed, Treasury estimates 15% of small insurers do not respond to the annual data call mandated by Congress. Treasury will not even hazard a guess as to the percentage of captive insurers that do not provide data.

No private reinsurer would fly blindly without a list of who it reinsures and at least some idea of the exposures it has assumed from them. It is simply unreasonable for Treasury to continue to do so.

The Register should be Available to those who Ultimately Foot the Bill for TRIA

Many states have concluded extraordinary "confidentiality is warranted for pure captive transactions, because such coverage written is only for the parent company and its subsidiaries . . . [so] there is generally no public interest in their business plan." NAIC White Paper (July 2013).

As the research in this paper reveals, there is indeed a compelling public interest for US small businesses, churches, school districts and other commercial property and casualty insurance consumers to know which global corporates have decided to put them at risk for billions in surcharges.

The Necessary Information is Not Sensitive

Treasury should amend its claim procedures to condition any backstop reimbursement on the insurer having accurately maintained its registration with Treasury including:

- Identity of the companies in the insurer group
- Identity of the ultimate parent
- Backstop deductible calculation
- Terrorism insurance limits (for captives)

NY has made such information public for years with no complaints.

Treasury has the Know-How

For the last five years Treasury has maintained and made public a registry of 351,868 foreign banks, insurance companies and other financial institutions under FATCA. A TRIA registry would be a mere 1% of the size of the FATCA registry.

Treasury has the experience of a successful round up and registration of financial institutions from more than two hundred countries. Keeping a list of insurance companies from the 50 states that want to ensure they can collect tens or hundreds of millions of dollars from the backstop would be simple in comparison.

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For the reasons stated in the paper, Treasury should propose the following new rule:

§ 50.18 Registry of Participating Insurers

(a) As a condition for Federal payments under section 103(b) of the Act, each insurer shall submit to Treasury a Notice of Registration on a form prescribed by Treasury by April 1 of each calendar year.

(b) The Notice of Registration shall require at least the following information:

(1) Identity of the insurer, if not part of an affiliate group of insurers, or identity of the affiliate group of insurers;
(2) Identity of the ultimate parent of the insurer or affiliate group of insurers;
(3) A calculation of the backstop deductible of the insurer or affiliate group of insurers for that calendar year; a
(4) Terrorism insurance limits of policies issued, in the case of a captive insurer; and
(5) The name and contact information of a responsible officer for the insurer or affiliate group of insurers.

(c) Treasury shall publish the information described in paragraph (b)(1) – (b)(4) of this section by June 1 of each calendar year on Treasury's Web site.