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Director of Insurance

REGULATORY BULLETIN 2006-03¹

TO: ALL PROPERTY & CASUALTY INSURERS, ALL RATING ORGANIZATIONS, ALL ADVISORY ORGANIZATIONS, AND ALL OTHER INTERESTED PARTIES

FROM: CHRISTINA URIAS
DIRECTOR OF INSURANCE

DATE: JANUARY 26, 2006

RE: **VOLUNTARY EXPEDITED FILING PROCEDURES FOR COMPLIANCE WITH THE PROVISIONS OF THE TERRORISM RISK INSURANCE EXTENSION ACT OF 2005**

Background

The Arizona Department of Insurance (“ADOI”) hereby withdraws its Regulatory Bulletin 2004-3 and issues this Bulletin in conjunction with the National Association of Insurance Commissioners (“NAIC”) to inform interested parties of recent developments regarding this matter.

Due to the uncertainty in the commercial lines property and casualty insurance and reinsurance markets as a result of the substantial industry losses on September 11, 2001, Congress enacted and the President signed the Terrorism Risk Insurance Act of 2002 (“Act”), to provide a temporary federal backstop to calm market fears over future terrorist attacks and assist the insurance industry in allocating capital to provide coverage for these unpredictable and potentially catastrophic events. The Act provided a federal backstop for defined acts of terrorism and imposed certain obligations on insurers. Recently, Congress and the President revised and extended the Act for an additional two years (through December 31, 2007) with the enactment of the Terrorism Risk Insurance Extension Act of 2005 (“Extension Act”).

The Extension Act changes include: (1) deletion of commercial auto, burglary and theft, surety, professional liability, and farm owners multi-peril coverages; (2) an increase in the individual company deductible for 2006 to 17.5 percent and for 2007 deductible to 20 percent; (3) an increase in the industry aggregate retention level from \$15 billion to \$25 billion in 2006 and to \$27.5 billion in 2007; (4) reduction in the federal share of compensation for covered losses from 90 percent to 85 percent for 2007; (5) maintaining the \$5 million

¹ This Substantive Policy Statement is advisory only. A Substantive Policy Statement does not include internal procedural documents that only affect the internal procedures of the Agency, and does not impose additional requirements or penalties on regulated parties or include confidential information or rules made in accordance with the Arizona Administrative Procedure Act. If you believe that this Substantive Policy Statement does impose additional requirements or penalties on regulated parties you may petition the agency under Arizona Revised Statutes Section 41-1033 for a review of the Statement.

threshold for certification of a terrorist act, while establishing a per event trigger for federal participation in aggregate insured losses of \$50 million for losses occurring after March 31, 2006 and before January 1, 2007 and to \$100 million for losses occurring in the 2007 Program Year; (6) extension of existing litigation management provisions and codification of regulations requiring submission and approval of proposed settlements; and, (7) directing the President's Working Group on Financial Markets to study long-term availability and affordability of coverage for terrorism losses, including group life and nuclear, biological, chemical and radiological events. The Extension Act directs the President's Working Group on Financial Markets, in consultation with NAIC representatives, the insurance and securities industries and policyholders, to submit a report of its findings to the House Financial Services and Senate Banking Committees by September 30, 2006.

The intent of this Regulatory Bulletin is to advise you of certain provisions of the Extension Act that may require insurers to submit a filing of the disclosure notices, policy language and the applicable rates, although, in many cases, insurers' current filings will be adequate.

Subsection 102(6) of the original Act defines as "any entity and affiliate thereof--(A) that is--(i) licensed or admitted to engage in the business of providing primary or excess insurance in any State; (ii) an eligible surplus line carrier listed on the Quarterly Listing of Alien Insurers of the NAIC, or any successor thereto; (iii) approved for the purpose of offering property and casualty insurance by a Federal agency in connection with maritime, energy, or aviation activity; (iv) a State residual market insurance entity or State workers' compensation fund; (B) that receives direct earned premium for any type of commercial property and casualty insurance coverage." The Secretary of Treasury may extend the Extension Act to other classes or types of captive insurers, other self-insured arrangements by municipalities, and other entities, including group life insurers.

Subsection 102(12) of the original Act states that the term "property and casualty insurance" means "(A) commercial lines of property and casualty insurance, including excess insurance, workers' compensation insurance, and directors and officers liability insurance; and, (B) does not include crop or livestock insurance, private mortgage or title insurance, financial guaranty insurance issued by monoline financial guaranty insurance corporations, medical malpractice, health or life insurance including group life, flood insurance provided under the National Flood Insurance Act, reinsurance or retrocessional reinsurance, commercial automobile insurance, burglary and theft insurance, surety insurance, professional liability insurance, or farm owners multiple peril insurance."

Section 102(6) of the original Act requires all insurers (as defined therein) to participate in the Terrorism Insurance Program ("Program") and make coverage available for insured losses in all of their covered commercial lines policies. The term "*insured loss*" means any loss resulting from an act of terrorism (including an act of war, in the case of workers' compensation) that the insurer's primary or excess property and casualty insurance covers, if such loss—(A) occurs within the United States; or, (B) occurs in an air carrier (as described in section 40102 of title 49, United States Code), to a United States flag vessel (or a vessel based principally in the United States, on which United States income tax is paid and whose insurance coverage is subject to regulation in the United States), regardless of where the loss occurs, or at the premises of a United States mission. Section 107(a)(5) of the original Act also advises that *insured losses* exclude punitive damages awarded in a civil action and further requires insurers to make available property and casualty insurance coverage for *insured losses* that do not differ materially from the terms, amounts, and other coverage limitations applicable to losses arising from events other than acts of terrorism.

Certified and Non-Certified Losses

As a result of the definition of *insured loss* contained in the original Act (Section 102(5)), there are essentially two distinct types of losses that a business might face as a result of terrorism: “*certified losses*” and “*non-certified losses*.” A “*certified loss*” occurs as a result of a certified act of terrorism, will always involve a foreign person or foreign interest, and is an *insured loss*. See Sections 102(1)(A) & (B). A “*non-certified loss*” may not involve a foreign person or foreign interest and may not fit within the definition of *insured loss*.

Arizona has allowed, and will continue to allow, some significant limitations that provide coverage for acts of terrorism under certain circumstances.

For policies providing property insurance coverage the following limitations apply to *non-certified losses*:

- Exclusion for acts of terrorism only apply if the acts of terrorism result in industry-wide insured losses that exceed \$25,000,000 for related incidents that occur within a 72 hour period;
- Exclusions for acts of terrorism are not subject to the limitations above if:
 - The act involves the use, release or escape of nuclear materials, or that directly or indirectly results in nuclear reaction or radiation or radioactive contamination;
 - The act is carried out by means of the dispersal or application of pathogenic or poisonous biological or chemical materials; or,
 - Pathogenic or poisonous biological or chemical materials are released, and it appears that one purpose of the terrorism was to release such materials.

For policies providing liability insurance coverage the following limitations apply to *non-certified losses*:

- Exclusion for acts of terrorism only apply if the acts of terrorism result in industry-wide insured losses that exceed \$25,000,000 for related incidents that occur within a 72 hour period; or,
- Fifty or more persons sustain death or serious physical injury for related incidents that occur within a 72-hour period. For purposes of this provision serious physical injury means:
 - Physical injury that involves a substantial risk of death;
 - Protracted and obvious physical disfigurement; or,
 - Protracted loss of or impairment of the function of a bodily member or organ.
- Exclusions for acts of terrorism are not subject to the limitations above if:
 - The act involves the use, release or escape of nuclear materials, or that directly or indirectly results in nuclear reaction or radiation or radioactive contamination;
 - The act is carried out by means of the dispersal or application of pathogenic or poisonous biological or chemical materials; or,
 - Pathogenic or poisonous biological or chemical materials are released, and it appears that one purpose of the terrorism was to release such materials.

Definition of Act of Terrorism

Section 102(1)(A) of the original Act defines an *act of terrorism* as, “any act that is certified by the Secretary of the Treasury, in concurrence with the Secretary of State, and the Attorney General of the United States—(i) to be an act of terrorism; (ii) to be a violent act or an act that is dangerous to—(I) human life; (II) property; or (III) infrastructure; (iii) to have resulted in damage within the United States, or outside the United States in the case of—(I) an air carrier or vessel described in paragraph (5)(B); or (II) the premises of a United States mission; and (iv) to have been committed by an individual or individuals acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States Government by coercion.” Section 102(1)(B) states, “No act shall be certified by the Secretary as an act of terrorism if—(i) the act is committed as part of the course of a war declared by the Congress, except that this clause shall not apply with respect to any coverage for workers’ compensation; or (ii) property and casualty insurance losses resulting from the act, in the aggregate, do not exceed \$5,000,000.” Section 102(1)(C) and (D) specify that the determinations are final and not subject to judicial review and that the Secretary of the Treasury cannot delegate the determination to anyone.

Arizona will not allow exclusions of coverage for acts of terrorism that fail to be *certified losses* solely because they fall below the \$5,000,000 threshold in Section 102(1)(B) on any policy that provides coverage for *certified losses*. Insurers required to file policy forms may submit language containing coverage limitations for *certified losses* that exceed \$100 billion.

This Regulatory Bulletin adopts the definition of *acts of terrorism* to mean *certified losses*. Policies subject to policy form filing requirements should also define what constitutes an *act of terrorism* for *non-certified losses*. For *non-certified losses*, Arizona would accept the following definition, or one that is more liberal to policyholders:

The phrase “non-certified act of terrorism” means a violent act or an act that is dangerous to human life, property; or infrastructure that is committed by an individual or individuals and that appears to be part of an effort to coerce a civilian population or to influence the policy or affect the conduct of any government by coercion, and the act is not certified as a terrorist act pursuant to the Federal Terrorism Risk Insurance Act of 2002.

Submission of Rates, Policy Form Language and Disclosure Notices

If an insurer relies on a rating organization to file rates and related rating systems on its behalf, the Department does not require a rate filing unless an insurer plans to use a different rate than the rating organization files for coverage for *certified losses*. The rate filing should provide sufficient information for the reviewer to determine what price the insurer would charge to a business seeking to cover *certified losses*. Arizona will accept filings that contain a specified percentage of premium to provide for coverage for *certified losses*. Insurers may also use rating plans that consider other factors such as geography, building profile, proximity to target risks and other reasonable rating factors. The insurer’s filing should include the basis for its selection of rates and rating systems and include supporting documentation sufficient for the reviewer to determine if the rates are excessive, inadequate or unfairly discriminatory. For the convenience of insurers, Arizona will waive its supporting documentation requirement for *certified loss* rates on filings that apply an increased premium charge of between 0% and 10% and do not vary by application of other rating factors.

The Director's Order, Docket No. 05A-108-INS, filed October 21, 2005 ("2005 Order") possibly exempted some forms in certain lines or sublines of insurance from the A.R.S. § 20-398(A) form filing requirements and/or may require no changes, however, pursuant to Exhibit A, Section II(C) of the 2005 Order, the Director hereby expressly directs insurers to file with the Department, all forms that require an amendment to the policy's existing terrorism clause. The policy should define *acts of terrorism* and both *certified* and *non-certified losses* in ways that are consistent with the original Act, state law and the guidance provided in this Regulatory Bulletin. The insurer should file complete definitions, terms and conditions and accurately describe the coverage the insurer will provide in the policy. Insurers and/or rating organizations should withdraw or properly amend previous filings that include lines of insurance that the insurer has deleted from eligibility under the Extension Act (i.e. commercial auto, burglary and theft, surety, professional liability, and farm owners multiperil). Insurers may conclude that current filings are in compliance with the Extension Act, state law and the requirements of this Regulatory Bulletin.

The Director requests the insurers file disclosure notices for informational purposes, along with the policy forms, rates and rating systems, as they are an integral part of Arizona's process for policyholder notification and the Department wants to make sure the notices are clear and not misleading, and are in compliance with the requirements of the Extension Act and consistent with the policy language and rates filed by the insurer.

Effect on Workers' Compensation Insurance Coverage

Treatment of workers' compensation under the Extension Act is slightly different than for other property and casualty insurance coverage... First, Section 102(1)(B)(i) of the original Act provides that the federal program will share the risk of loss for workers' compensation for acts of war in addition to *acts of terrorism* because of the statutory nature of the workers' compensation program, which does not provide an exclusion for losses resulting from an act of war. Under Arizona law there is no exclusion for workers' compensation losses resulting from an act of war. There is no provision in the Extension Act that would preempt the compulsory coverage aspects of workers' compensation insurance policies. In other respects, however, the Extension Act treats workers' compensation coverage as any other covered line of insurance. Therefore, the notice requirements of Section 103(b)(2) of the original Act and the mandatory "make available" requirements of Section 103(c) of the original Act apply to workers' compensation policies. In this connection, the original Act requires workers' compensation insurers to separately state (the amount of) the estimated portion of the premium charged for *acts of terrorism*, as defined therein. Because Arizona's workers' compensation law does not have any exclusions for terrorism or war, neither insurers nor policyholders may create such an exclusion. The original Act also covers workers' compensation insurers with regard to the filing and approval of rates and forms. In Arizona, the National Council on Compensation Insurance, Inc. ("NCCI") makes all rate and form filings and shall make filings as to terrorism on behalf of its members transacting workers' compensation in Arizona.

Optional Provision for Standard Fire Policy States

In Arizona, HB2192 (Ch. 218, Laws 2005) amended the Standard Fire Policy to permit insurers to exclude acts of terrorism from the policy. Specifically, A.R.S. § 20-1503(B) states:

The Arizona standard fire policy may exclude coverage for loss by fire or other perils insured against if the loss is caused directly or indirectly by terrorism and involves risks other than a type of risk to which Article 12 [Homeowners] of this chapter applies.

Effective Date

This Regulatory Bulletin shall take immediate effect and shall expire on December 31, 2007, unless Congress further extends the duration of the Extension Act.

Any questions related to this Regulatory Bulletin are to be directed to Dean Ehler, Assistant Director, Property & Casualty Division via email (Dehler@id.state.az.us) or telephone (602-364-3453).