

carriers but, instead, issue and service their policies directly.

As mentioned in Interim Guidance II, Treasury has consulted with the NAIC to develop a proposed allocation methodology that is in accord with statutory requirements. In order to implement the requirements of section 103(d)(2)(B) (no separate treatment) and 103(d)(3) (inclusion of premium income) for State residual market insurance entities that share profits and losses with private sector insurers, Treasury is proposing the following methodology for allocating direct earned premiums across all insurance companies that participate in the residual market mechanism.

First, premiums written by a servicing carrier, on behalf of a State residual market insurance entity and ceded to such an entity shall not be included as "Direct Earned Premium" for purposes of calculation of that servicing carrier's deductible.

Second, premium distributed to or assumed by State residual market participants, whether directly from the State residual market insurance entity or as quota share insurers of risks written by servicing carriers, is included in "Direct Earned Premium" for purposes of calculation of each pool participant's deductible.

These two proposed provisions would allocate risk within a State residual market mechanism to the ultimate risk bearers. Because servicing carriers do not hold the entire risk for the policies that they service for the State residual market insurance entity, the premium from those policies should not fully accrue to the servicing carrier. The servicing carrier does absorb risk within the State residual market mechanism, and the appropriate portion of such risk would be allocated back to the servicing carrier and other residual market participants in the second step. The net effect of these offsetting exclusions and inclusions will be no change in total industry-wide "Direct Earned Premium," but rather a reallocation to account for the unique nature of State residual market insurance entities.

The following provides an illustration as to how insurers that participate in State residual market insurance mechanisms should calculate their "direct earned premium" for purposes of calculating an "insurer deductible" as defined in section 102(7):

(1) Start with the appropriate measure of direct earned premium as specified in 31 CFR 50.5(d)(1) or 50.5(d)(2). That measure would include appropriate adjustments for personal insurance coverage as described in section 50.5(d)(1).

(2) Subtract the value of direct earned premium earned by servicing carriers and ceded to State residual market insurance entities if those direct earned premiums are reported in step 1.

(3) Add direct earned premium assumed from or distributed by State residual market insurance entities to insurers participating in the State residual market mechanism.

Although no report or information is requested or proposed at this time, Treasury may later request that the administrator of a qualifying State residual market entity provide Treasury with certified information about the aggregate premium and losses, and participant allocation information that it provides to participating insurance companies if, and to the extent, deemed to be needed by Treasury to verify insurers' "deductible" calculations.

C. Other State Residual Market Insurer Issues

Treasury has not yet issued regulations regarding the federal share of insured losses as described in section 103(e)(1)(A) of the Act; however, consistent with the treatment of premium income described above, Treasury is considering proposing that insured losses arising from policies insured through State residual market insurance entities described in section 103(d)(2)(B) be calculated for each residual market insurance participant based on each such insurer's share of the insured losses of the State residual market entity as allocated to the insurer by the residual market entity. Treasury is also considering proposing that the State residual market insurance entity provide an allocation of insured losses to each participant and other information related to the sharing of insured losses among residual market participants as part of regulations issued under the claims verification process. Treasury specifically solicits comment in these areas.

As regulations regarding the Federal share of insured loss and the claims verification process are developed, Treasury will also be considering the general issue of how the insolvency of insurers under the Program will be addressed, and in particular how the insolvency of a residual market participant or a servicing carrier affects the allocation of insured losses among residual market participants. Although Treasury has no specific proposal, Treasury also solicits comment on these issues.

D. Disclosure

In Interim Guidance II, Treasury did not require disclosures under section

103(b)(2) of the Act by insurers that fall under section 102(6)(A)(iv), if such State residual market and workers' compensation fund insurers did not have sufficient information to make such disclosures under section 103(b)(2), pending issuance of final regulations. Treasury is still evaluating the applicability of the disclosure requirement on certain insurers in this category and solicits information on this issue.

III. Procedural Requirements

This proposed rule is a significant regulatory action and has been reviewed by the Office of Management and Budget under the terms of Executive Order 12866.

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this proposed rule will not have a significant economic impact on a substantial number of small entities. The Act itself requires State residual market insurance entities and State workers' compensation funds to participate in the Program, and these entities or funds are generally not small entities.

The Act itself requires all licensed or admitted insurers to participate in the Program. This includes all insurers regardless of size or sophistication. Although insurers that participate in sharing profits and losses of a State residual market insurance entity or State workers' compensation fund may include small entities, the proposed rule is based on existing business practices of residual market entities in determining the impact on participating insurers. The Act also defines property and casualty insurance to mean commercial lines without any reference to the size or scope of the commercial entity. Accordingly, any economic impact associated with the proposed rule flows from the Act and not the proposed rule. However, the Act and the Program are intended to provide benefits to the U.S. economy and all businesses, including small businesses, by providing a federal reinsurance backstop to commercial property and casualty insurance policyholders and spreading the risk of insured loss resulting from an act of terrorism. Accordingly, a regulatory flexibility analysis is not required.

List of Subjects in 31 CFR Part 50

Terrorism risk insurance.

Authority and Issuance

For the reasons set forth above, 31 CFR part 50 is proposed to be amended as follows: