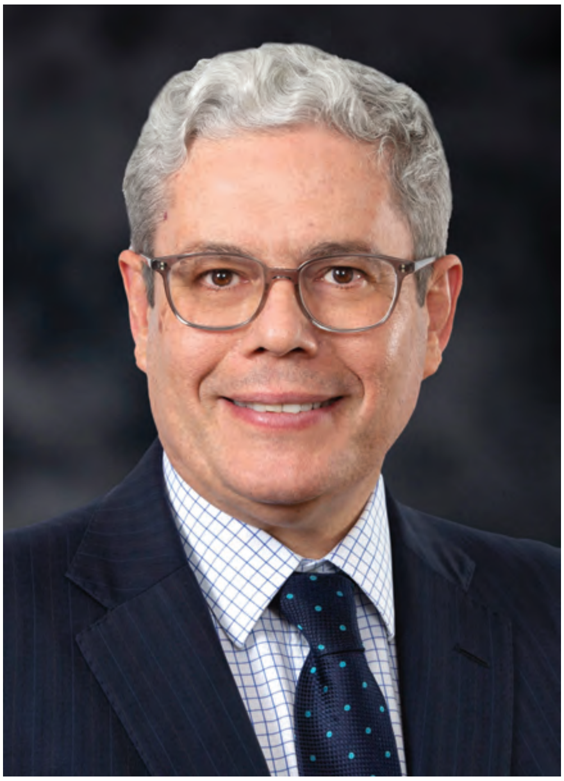

The complexity of terrorism pools

The events of 9/11 prompted governments around the world to reassess how they dealt with terrorism risk with the result that many set up their own 'terrorism pools'. The **Australian Reinsurance Pool Corporation** was set up under the Terrorism Insurance Act 2003 to address the government's concern about the lack of comprehensive insurance cover for commercial property or infrastructure that could lead to a reduction in financing and investment in the Australian property sector. We spoke to chief executive **Dr Christopher Wallace** about the changing nature of cover offered by terrorism pools today.

By Paul McNamara

Sydney-headquartered Australian Reinsurance Pool Corporation (ARPC) consists of a small team of around 22 staff but manages to oversee a scheme with a total value of more than A$13bn ($9.39bn). Heading ARPC is Dr Christopher Wallace, a seasoned insurance industry veteran with experience in general insurance, health insurance and reinsurance. Before joining ARPC in 2013 he worked at GIO General Insurance, EY and the Hospitals Contribution Fund.

A look at the numbers

ARPC published its annual report in October 2018, showing a healthy set of numbers with most of its business affairs run in-house – including asset management. "Our net assets at 30 June were A$426m," Dr Wallace said. "And we hold that as a reserve for future claims. We have a retrocession reinsurance programme, and from that our deductible is A$285m. In a large loss event, we would draw on the remaining part of the retrocession programme which is currently A$3.065bn. What that means is in 90-95 % of loss scenarios, ARPC can fund the claims payments on those, either from its net assets or from the retrocession programme. So, Australian tax payers are protected from having to fund those losses."

"In very extreme scenarios, in a tail exposure, we have a further A$10bn of financial support from the Australian government through a Commonwealth guarantee. That gives us a total funding of roughly A$13.4bn. Investments are around A$500m and, because we are an Australian government public financial corporation, we comply with rules around investments.

"We place that with Australian banks in fixed interest term deposits. This means the money is available at relatively short notice to pay claims, but we get a good return on those investments. Since we are backed by the Australian government's AAA credit rating, financial institutions in Australia are quite keen to take our deposits. We could also place funds into Australian government bonds but, at present, we place it into term deposits because we get a higher rate of return."

Investment strategy

The execution of an investment strategy that consist largely of investing in bank term deposits seems quite straightforward, but where is the investment strategy set? "We have an ARPC board, appointed by the government," said Dr Wallace.

"The board has responsibility for governance of the organisation and oversight, and the board has set an investment policy which we work within. The investment policy also operates within rules that are set out. We have to comply with the Public Governance Performance and Accountability Act which sets out the requirements for investments," Dr Wallace said.

"We structure our investments to be able to draw on money based on what we expect a claim payment profile would look like in a large loss event. It would be no good for us to put it all into a two-year fixed interest bond or deposit that we can't access if there is a loss. We have a payment pattern expectation in a loss event and we structure our investments to maintain the ability to meet our claim payment obligations in the event of a loss and to maximise our returns within this liquidity constraint. It works very well for us and we have regular interactions with the financial markets here, transacting those investments."

Healthy returns

According to last year's annual report ARPC made a return of A$13.7m on its investments. What happens to this at the end of the year? "We keep the surplus and add it to our assets," said Dr Wallace. "We expect our net assets to increase over the next four years from A$426m to roughly A$500m. We are a reinsurance company. Where we can, we want to build up our net assets gradually."

"We receive premium income and we use that to pay the government. We pay the government compensation for the financial support we receive for the guarantee. We pay the government a capital holding fee because we hold our net assets separately to the government. And we also pay a dividend. We also buy a retrocession programme. Last year we spent A$58.5m buying reinsurance from Australian and global reinsurers."

Staying current

One of the challenges that all terrorism pools face is staying up-to-date with the changing nature of terrorism threats such as cyber threats. This is an area where ARPC is very active and towards the end of October, it announced that it had commissioned Cambridge Centre for Risk Studies and the Organisation for Economic Co-operation and Development to undertake a year-long research project with ARPC that will look at the threat of cyber terrorism in Australia, including the nature and cost of physical damage to commercial property that may be caused by acts of cyber terrorism.

Cambridge Centre for Risk Studies has already undertaken several projects in this area, working with Lloyd's of London and Pool Re, the British terrorism pool.

Physical damage only

"At present, the ARPC scheme provides cover for private sector commercial property assets and also high value residential assets," said Dr Wallace. "And the reason we provide cover for terrorism risk is there is insufficient capacity in the private market to cover these assets. We operate as a property treaty reinsurer and we provide this cover to our customers who are the insurance companies providing cover to property owners.

"Our scheme was set up in 2003 and, when we were established, an exclusion was put into our regulations for computer crimes. Our view is that computer crime exclusion in our regulations would mean that ARPC would not respond if there was a cyber terrorism attack that caused physical damage to a building," Dr Wallace said.

An example of this might be a situation where a virus infected a laptop in an office overnight, causing it to overheat and start a fire in which the office and building are damaged.

Narrow definition of computer crime

"In that scenario, the computer crime exclusion would mean that the scheme would not respond because it was caused by computer crime," said Dr Wallace. "Whereas, if someone had caused a more conventional attack – a bombing or damage to a building through some other means - the scheme would respond."

The announced research study will, therefore, have a narrow focus. "We presently don't cover cyber terrorism and the area of risk we have focused on is fire, water damage and damage to the physical premises as a result of cyber terrorism," Dr Wallace said. "We are not really looking at the intellectual property or intangible losses or financial losses that might arise."

There is currently no intention to extend the study to take a more comprehensive look at cyber terrorism coverage. "No, it is not on our minds," said Dr Wallace. "We are really focused on this gap in our cover and seeing whether it is possible to address it or not. For it to be addressed, it would require the government to have the appetite to address the risk."

"We need to be able to explain it very clearly and to quantify it and put a price on it. So, this piece of work is to be able to build the information base that would help the treasury department of the government to understand the exposure and the initial responses to it. It is very much a foundational research project. We are not looking at the broader cyber insurance market which is developing very rapidly but we are looking at the physical damage part of it."

> "We are expanding our modelling capability to cover the whole of Australia using geospatial databases that are available commercially.

Other major projects

In addition to the cyber research project, APRC is also fully engaged in three large projects at present and, at the time of writing, is awaiting the treasury department's three-year review of the scheme. "The review is to assess if there is a need for the scheme to continue," said Dr Wallace. "We look forward to that being published and when it is published, we will work with our stakeholders to communicate the findings. Previous reviews have seen improvements to the scheme and enhancements to what we do."

ARPC is also working on improving its modelling. "Presently we have high-resolution models of all the capital cities in Australia for conventional terrorism attack," said Dr Wallace. "But we are expanding our modelling capability to cover the whole of Australia using geospatial databases that are available commercially."

Finally, ARPC is working with Standards Australia on the Physical Protective Security Treatments for Buildings Handbook, which is described as a plain English handbook to support proactive risk management of large-scale infrastructure like commercial buildings. "That handbook will also cover terrorism risk," said Dr Wallace. "It'll provide a single reference point where a business can get guidance on what security treatments guidelines are available to reduce the risk for their infrastructure of terrorism. I expect that would be published in the course of next year."