Terrorism Insurance Act Review: 2006

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EXECUTIVE SUMMARY

The Australian Government established a terrorism insurance scheme to minimise the wider economic impacts that flowed from the withdrawal of terrorism insurance in the wake of the terrorist attacks in the United States of America on 11 September 2001. The Government's objective is to operate the scheme only while terrorism insurance cover is unavailable commercially on reasonable terms. As such, the *Terrorism Insurance Act 2003* (the Act) requires the Treasurer to provide a report that reviews the need for the Act to continue in operation, at least once every three years.

Having consulted key stakeholders and considered international experience, the review concluded that there is still a need for the Act to continue in operation, subject to further review in no more than three years. While the market for terrorism insurance has recovered somewhat since the scheme was introduced, insufficient terrorism insurance is currently available commercially on reasonable terms.

The key features of Australia's terrorism insurance scheme are consistent with the 'best practice' model supported by the Organisation for Economic Cooperation and Development (OECD). The Australian Reinsurance Pool Corporation (ARPC), established under the Act to administer the scheme, is efficient and prudent, and is well regarded by stakeholders.

A number of issues raised by stakeholders regarding the operation of the scheme have been considered.

Having considered these issues, in relation to the scope of the terrorism insurance scheme, it is recommended that the scheme be modified to cover commercial insurance provided in relation to all public authorities.

To encourage greater involvement of the commercial sector in providing terrorism risk cover, it is recommended that:

- the ARPC be required to continue charging premiums for reinsurance at the current rates, subject to further review in no more than three years;
- once the pool reaches $300 million, the ARPC have discretion to determine whether to use premiums to build the pool further, purchase reinsurance for the scheme or undertake a combination of the two;

- insurer retentions under the scheme be increased in three increments (with effect, respectively, from 1 July 2007, 1 July 2008 and 1 July 2009), as follows:

Date	Annual insurer retention		Maximum industry retention per incident
	Minimum	Maximum	
Current	Nil	The lesser of $1 million or 4 per cent of fire and ISR premiums collected	$10 million
1 July 2007	$100,000	The lesser of $1 million or 4 per cent of fire and ISR premiums collected	$25 million
1 July 2008	$100,000	The lesser of $5 million or 4 per cent of fire and ISR premiums collected	$50 million
1 July 2009	$100,000	The lesser of $10 million or 4 per cent of fire and ISR premiums collected	$100 million

- in relation to bundled insurance policies, the ARPC be required to only charge reinsurance premiums on those sections of the policy that exclude terrorism risks.

INTRODUCTION

AUSTRALIA'S TERRORISM INSURANCE SCHEME

Insurance plays an important role in the economy. It allows for the transfer of risk to those best placed to manage it. This risk transfer allows individuals and businesses to undertake economic activities that would otherwise not take place, because of their risks. Insurers cover the individual or business purchasing the insurance policy and redistribute their risk through investment and reinsurance arrangements.

The destruction of the World Trade Center in New York on 11 September 2001 changed the way insurers looked at terrorism risk. Insurers and reinsurers sustained previously unimaginable losses. They realised that they were covering terrorism risk virtually free of charge. They decided to reduce their exposure to terrorism, or to stop covering the risk.

With a large pool of assets uninsured for terrorism risk, the uncertainty facing financiers and investors had the potential to result in broad economic impacts, by delaying the commencement of investment projects and altering portfolio management decisions.

The Australian Government was concerned that the lack of comprehensive insurance cover for commercial property or infrastructure would lead to less financing and investment in the Australian property sector, with subsequent wider economic impacts. It therefore established the terrorism insurance scheme, to provide the reinsurance to insurers that had been withdrawn by commercial reinsurers. In general terms, this covers all commercial property in Australia and associated business interruption losses and public liability claims.

Businesses with insurance will benefit from the scheme in the event of a terrorist act affecting them either directly, through property damage, or indirectly, through business interruption.

The Government established the scheme as an interim measure, to operate only while terrorism insurance cover was unavailable commercially on reasonable terms. For this reason, it included in the *Terrorism Insurance Act 2003* (the Act) a requirement to review the need for it to continue in operation, at least every three years.

ROLE OF INSURANCE AND REINSURANCE

Insurance is a sizeable industry in its own right. At 30 June 2005, the Australian general insurance industry had $77.8 billion in total assets and $53 billion in total liabilities, while reporting $27.3 billion in gross premium revenue and $18.3 billion in gross incurred claims. In June 2005 there were 133 private sector insurers authorised to operate in Australia, with 112 of them direct insurers and 21 reinsurers.[1]

The insurance industry absorbs risk from other industries and spreads it through the local and global insurance market. This risk transfer allows individuals and businesses to undertake activities that would otherwise not take place, or could not continue to operate in the same way, if the insurance industry did not exist. For example, the banking industry requires insurance protection on assets used as collateral for loans.

Accordingly, the insurance industry's safety is important, not only for the protection of individual policyholders, but also for the stability of, and confidence in, the wider economy.

Insurers write coverage directly with the individual or business purchasing a policy and then redistribute the risk through investment and reinsurance arrangements.

Insurers are usually under no obligation to seek reinsurance. Whether to obtain reinsurance is a business decision, based on the amount and type of risk exposure they retain. However, in practice, insurers rely heavily on reinsurance to manage their risk.

Reinsurance is a global business, covering risks from insurers in many different countries from around the world. Reinsurers are better able to assume certain risks than insurers because they diversify their risk portfolios globally.

Reinsurance allows insurers to limit their risk exposure on an individual policy, or on a group of policies, and to underwrite more and larger individual risks than they would otherwise be willing or able to cover.

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1 Australian Prudential Regulation Authority *Statistics: half yearly general insurance bulletin June 2005*, 30 March 2006, 6-7. <http://www.apra.gov.au/Statistics/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=10520>

The industry would be unlikely to offer as much insurance to the public if adequate reinsurance was not available. Reinsurers are effectively the wholesalers of insurance and have a significant effect on the cover sold to the public and its price.

WITHDRAWAL OF TERRORISM INSURANCE

There are a number of factors that affect the availability and affordability of insurance. Because of these factors, it is not possible to insure every risk at all times.

For a risk to be insurable, it must be measurable, well understood and bounded. Premium rates must be acceptable to insurers and to their customers.[2] That is, insurers must be able to set premiums for each potential customer or class of customers. Insurers also have to be able to identify and quantify, or estimate at least partially, the chances of the insured event occurring and the extent of losses likely to be incurred, to set their premiums.[3]

While a risk may be insurable, its insurance may not be profitable. It may not be possible to set a rate for which there is sufficient demand and revenue to cover the development, marketing, operating and claims-processing costs of the insurance and produce a profit over a specified period. If it is not profitable, the insurer will not offer insurance to cover the risk.[4]

Before the 11 September 2001 attack on the World Trade Center, many Australian and overseas insurers considered the risks posed by terrorism to be negligible, so its cover was implicitly included in most insurance contracts, as part of general 'all-risks' cover.

2 Swiss Reinsurance Company 'Innovating to insure the uninsurable' *Sigma* 4/2005, 3. <http://www.swissre.com/INTERNET/pwswpspr.nsf/fmBookMarkFrameSet?ReadForm&BM=../vwAllbyIDKeyLu/bmer-6gtaaw?OpenDocument>

3 Howard Kunreuther and Erwann Michel-Kerjan 'Terrorism insurance 2005' *Regulation* Spring 2005, 47. <http://grace.wharton.upenn.edu/risk/downloads/regulationmagazineHK-EMK.pdf >

4 Ibid.

Insurance covered most terrorism risks related to property and casualty loss, generally under fire policies that provided compensation for fire and explosion damage of almost any cause, except for some events such as war. Insurers saw terrorism as a manageable exposure so marginal that the additional risk was not subject to separate underwriting and pricing.[5]

The events of 11 September 2001 fundamentally changed the way the world — and insurers — looked at terrorism risk. Insurers and reinsurers sustained previously unimaginable losses. Nearly 150 insurers and reinsurers were responsible for covering the losses, with European reinsurers assuming the largest financial burden.[6] Total insured losses have been estimated at around US$40 billion.[7] At the time, this was nearly twice as large as the largest insured natural catastrophe in history, Hurricane Andrew. Total insured and uninsured losses from the World Trade Center are estimated at about US$100 billion. By way of comparison, total insured and uninsured losses from Hurricane Katrina are likely to be even greater.[8]

Event	Year	Insured loss
World Trade Center	2001	US$40 billion
Hurricane Katrina	2005	US$34.4 billion
Hurricane Andrew	1992	US$21 billion
Earthquake: Northridge	1994	US$17 billion
Winter storms in Europe	1999-2000	US$9 billion[9]

As a result of 11 September 2001, insurers realised that their coverage of landmark buildings included terrorism insurance virtually free of charge. While this was acceptable when terrorism risk seemed remote, the risk was no longer remote.[10]

This led both insurers and reinsurers to be more precise and detailed in specifying and pricing the risks and liability underwritten in their insurance

5 OECD *Policy issues in insurance No. 9: Terrorism risk insurance in OECD countries*, Paris 2005, 9-10.

6 Kunreuther and Michel-Kerjan, above n 3, 44.

7 OECD, above n 5, 150.

8 Hurricane Insurance Information Center. <http://katrinainformation.org/disaster2/facts/katrina_faq/>

9 Testimony of Jacques E. Dubois Chairman and CEO, Swiss Re America Holding on behalf of Swiss Re before the United States Senate Committee on Banking, Housing and Urban Affairs 18 May 2004, 4. <http://banking.senate.gov/_files/dubois.pdf>

10 Swiss Reinsurance Company, above n 2, 10.

policies. They were also more cautious in covering risks they had previously seen as routine.[11]

Reinsurance payments for the World Trade Center came in the wake of other expenses, triggered by a series of catastrophic natural disasters over the previous decade, and portfolio losses from stock market declines.[12] During 2001 and 2002, the reinsurance industry's capital contracted sharply. This hampered the industry's ability to cover large and difficult-to-insure risks.

Most reinsurers decided to either reduce their offers of terrorism cover drastically or to stop covering the risk. This limited the ability of insurers to spread their exposure to catastrophic terrorism risk. Without the ability to spread the risk of catastrophic losses, insurers sought to reduce their own exposures.

ECONOMIC IMPACT OF THE WITHDRAWAL OF TERRORISM COVER

In the face of these changes in the insurance industry, many commercial policyholders faced steep price increases or were unable to obtain terrorism coverage because of exclusions or the tighter underwriting environment. In turn, the lack of coverage had the potential to halt real estate transactions and construction projects and reduce employment.[13]

The lack of available or affordable terrorism insurance cover resulted in significant commercial and financial difficulties. It forced commercial property owners, banks, superannuation funds and fund managers to assume their own terrorism insurance risk, as existing policies expired and renewal policies explicitly excluded terrorism cover. These institutions were not set up to manage insurance risk.

With a large pool of assets uninsured for terrorism risk, the uncertainty facing financiers and investors had the potential to result in broad economic impacts, by delaying commencement of investment projects and altering portfolio management decisions.

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11 OECD, above n 5, 232.

12 Kunreuther and Michel-Kerjan, above n 3, 45.

13 R Glenn Hubbard and Bruce Deal 'The economic effects of Federal participation in terrorism risk' 14 September 2004.
< http://www.aiadc.org/AIAdotNET/Files/Public/TRIAReport91404.pdf>

In Australia, listed and unlisted property trusts own much of the commercial property. Banks and commercial property trusts became concerned with the amount of property without adequate cover. Banks were concerned because they had loaned money for buildings that were not insured adequately. If these buildings were destroyed, the banks had limited prospects of recovering their money. The commercial property trusts were concerned that the directors of these trusts were not able to fulfil their fiduciary duties by adequately insuring the trusts' assets. In addition, superannuation funds invest heavily in listed property trusts, so their members were also exposed to any losses resulting from terrorist incidents.

In order to protect themselves against loss, banks lending funds for the construction of commercial buildings and infrastructure usually require the property assets that secure the loan to be insured. If the underlying asset is not insured against terrorism, this risk is borne by the bank. Banks are in the business of managing credit risk, not insurance risk, so their alternative is not to make the loan. Economic theory suggests that a significant reduction in lending leads directly to a reduction in economic growth.[14]

The Australian Bankers Association considered that there was a risk that financiers would be unprepared to provide finance to some large projects or large-scale infrastructure if terrorism cover was withdrawn and the new assets were exposed to an uninsurable risk.

In 2002, the Treasurer noted in Parliament that such risks had already materialised in the United States, with one survey estimating that US$15.5 billion worth of construction projects had been suspended because of a lack of comprehensive insurance cover.[15]

A survey conducted by the Association of Risk and Insurance Managers of Australasia of its 500 members in early 2002 indicated that more than 40 per cent of companies had had terrorism excluded from policies renewed after 11 September 2001 and 64 per cent of those yet to renew had been told they would not get terrorism cover.[16]

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14 Geoff Atkins and Tim Pitt 'Terrorism insurance' 26(3) *Australian and New Zealand Institute of Insurance and Finance Journal* June/July 2003, 19.

15 Commonwealth of Australia Parliamentary Debates (Hansard) House of Representatives 12 December 2001, 10,261.

16 Parliament of Australia Parliamentary Library *Bills Digest No. 110 2002-03 Terrorism Insurance Bill 2002.* <http://www.aph.gov.au/library/pubs/bd/2002-03/03bd110.htm>

Pressure for government intervention from the insurance, property and banking industries became stronger in early 2002. There were calls for the Australian Government to commit itself to providing a financial safety net by being the insurer of last resort in claims arising from terrorist acts. Banks and property owners lobbied the Government to provide some sort of terrorism insurance cover.

Establishment of the Terrorism Insurance Scheme

The Australian Government was concerned that the lack of comprehensive insurance cover for commercial property or infrastructure would lead to less financing and investment in the Australian property sector and that this would subsequently have wider economic impacts. The Government concluded that there was a need for it to intervene.

A number of governments around the world reached the same conclusion and instituted government schemes.

The Australian Government determined in May 2002 that it should act to ensure the availability of terrorism insurance cover. Following this decision, the Treasurer announced that the Government would offer remainder insurance for losses above the cover available from individual insurers, possibly after a pooling arrangement.

The Government decided that any intervention should be consistent with:

- the need to maintain, to the greatest extent possible, private sector provision of insurance;
- the need to ensure that risk transferred to the Commonwealth is appropriately priced to minimise the impact on the Commonwealth's financial position, and to ensure that the Commonwealth is being compensated by those benefiting from the assistance;
- the need to allow the commercial insurance and reinsurance markets to step back in when they are able (that is, ensuring an appropriate exit strategy for Government); and
- the need to be compatible with global solutions.[17]

17 Treasurer's press release 31 of 21 May 2002. <http://www.treasurer.gov.au/tsr/content/pressreleases/2002/031.asp>

The Australian Treasury commissioned Trowbridge Consulting to review the availability of terrorism insurance in Australia in June 2002. Its assessment, completed with the assistance of Chiltington International, found that virtually no terrorism-related insurance cover was available for commercial property and business interruption. Where cover was available, it was at prices that far exceeded commercial property owners' perceived cost of the risk, with large excesses and relatively low maximum coverage, compared to the market cover previously available.

The Treasurer concluded in Parliament that an adequate supply of terrorism risk insurance did not appear likely to return in the short to medium term in either the domestic or global markets.[18]

OUTLINE OF THE TERRORISM INSURANCE SCHEME

After examining a number of overseas models, the Australian Government decided to adopt a hybrid pool/post-funded model. That is, a model based on a small pool, but predominately post-funded in the event of terrorism losses.

The Government established the terrorism insurance scheme through the Act, to replace terrorism insurance coverage for commercial property and associated business interruption losses and public liability claims.

Insurers had excluded liability for terrorism losses by including clauses to that effect in their insurance contracts. The Act, which commenced on 1 July 2003, overrides those terrorism exclusion clauses in 'eligible insurance contracts' to the extent the losses excluded are 'eligible terrorism losses' arising from a 'declared terrorist incident'.[19]

The Act makes these terrorism exclusion clauses ineffective for all classes of insurance included in the scheme, for those risks covered by the policyholder's insurance. This requires insurers to meet eligible claims, in accordance with the other terms and conditions of their policies.

In general, the terrorism insurance scheme covers all eligible insurance contracts applying to all commercial property in Australia and associated business interruption losses and public liability claims.

Businesses with insurance will benefit from the scheme if a terrorist incident affects them through either property damage or business interruption.

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18 Commonwealth of Australia Parliamentary Debates (Hansard) House of Representatives 12 December 2001, 10,261. <http://www.aph.gov.au/hansard/reps/dailys/dr121202.pdf>

19 Section 8.

The scheme covers contracts that insure:

- loss of, or damage to, eligible property that is owned by the insured;
- business interruption and consequential loss arising from loss of, or damage to, eligible property that is owned or occupied by the insured or an inability to use such property; or
- liability of the insured that arises out of the insured being the owner or occupier of eligible property.[20]

The Act defines 'eligible property' to be property located in Australia, namely:

- buildings (including fixtures) or other structures or works on, in or under land;
- tangible property that is located in, or on, such property; and
- property prescribed by regulation.[21] The *Terrorism Insurance Regulations 2003* (the Regulations) prescribe tangible property in, on or under the seabed.[22]

Cover is also available for Commonwealth and state business enterprises as well as Commonwealth owned airports leased commercially. Farms can also benefit from cover, if they hold insurance against business interruption.

The scheme does not cover contracts for such matters as workers' compensation, residential property and contents insurance, marine insurance, aviation insurance, motor vehicle insurance, life insurance, health insurance, private mortgage insurance, medical indemnity insurance and professional indemnity insurance.[23]

Insurers can, but do not have to, reinsure their terrorism risk exposure with the Australian Reinsurance Pool Corporation (ARPC), the statutory authority established by the Government under the Act to administer the scheme and to provide reinsurance cover for eligible terrorism losses. The ARPC has discretion to refuse to enter into a reinsurance agreement, where it considers that providing reinsurance would be contrary to public policy.

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20 Subsection 7(1).
21 Section 3.
22 Regulation 4.
23 Regulation 5.

The ARPC covers eligible terrorism losses for any declared terrorist incident covered by an eligible insurance contract where the insurer has a reinsurance agreement with the ARPC. 'Eligible terrorism losses' do not include a loss or liability arising from the hazardous properties of nuclear fuel, material or waste.[24]

Policyholders pay their premiums to the insurer in exchange for the insurer taking on their risks. Similarly, the premium an insurer pays to the ARPC is in exchange for the ARPC taking on the insurer's terrorism risk.

The ARPC's premium is a percentage of the underlying premium. Insurers may in turn pass on the cost of this reinsurance to their policyholders through their premium. This is a commercial decision for the insurer.

Premiums paid to the ARPC are neither a tax nor a levy. The premium replicates the commercial arrangements insurers make if they choose to buy commercial reinsurance.

The ARPC's reinsurance rates fall within three broad tiers and are set by Ministerial direction. The tiers are based on geographic location and identified by postcode. Central Business District areas of Australian cities with a population of over one million (that is, Sydney, Melbourne, Brisbane, Perth and Adelaide) form one tier, with a reinsurance rate of 12 per cent of the underlying premium. Urban areas of all state capital cities and cities with a population of over 100,000 (including Sydney, Melbourne, Brisbane, Perth, Adelaide, Gold Coast, Canberra, Newcastle, the Central Coast of New South Wales, Wollongong, Hobart, Geelong, the Sunshine Coast of Queensland, Townsville and Darwin) form the next tier, with a rate of 4 per cent of the underlying premium. The third tier comprises areas not allocated to those other tiers, with a rate of 2 per cent of the underlying premium.[25]

While the reinsurance rate is not indexed, it reflects any change in the underlying premium and thereby also reflects the risks factored into that premium. The Australian Government does not set the underlying premium the insurer charges its policyholders. The total amount the insurer charges a policyholder is a matter for each insurer to determine.

24 Above n 21.
25 *Treasurer to Australian Reinsurance Pool Corporation (Premiums) Direction 2003*.

The terrorism insurance scheme provides a six-layer model that will operate to spread the cost of any claims.

Layer	Element
First layer	Policyholder's liability for some risk through a possible excess or deductible.
Second layer	Retention of some risk by insurers.
Third layer	Pool of premiums paid to the ARPC for reinsurance, initially targeted to be approximately $300 million.
Fourth layer	Commercial line of credit for up to $1 billion funded by the pool of premiums.
Fifth layer	Commonwealth Government indemnity for up to $9 billion.
Sixth layer	Possible liability for some risk by policyholders, through the operation of the reduction percentage or policy limits.

The scheme operates to provide reinsurance for those risks covered by the policyholder's insurance. For example, over and above any excess or deductible, if a policyholder has a policy limit of $10 million but incurs a loss of $12 million, the scheme will cover the policyholder's losses up to $10 million. Also, if the policy covers some perils, such as fire, but the declared terrorist incident relates to biological contamination, then the scheme will not cover perils that are not covered in the policyholder's insurance contract.

A commercial insurance policyholder retains some risk. First, the insurance policy may set an excess or deductible. Second, if the Treasurer considers that a declared terrorist incident will have a cost for the Commonwealth (and therefore all taxpayers) greater than $10 billion, either by itself or when taken together with other claims on the scheme, the Treasurer must declare a reduction percentage, which will reduce the amount payable by the insurer to its policyholders. That is, a policyholder will not receive a full payout. However, policyholders may seek top-up cover from the commercial market, to make up any shortfall due to the declaration of a reduction percentage. Third, the policyholder would also bear some liability if the upper limit of their policy was lower than their actual loss, as noted above.

The policyholder's possible risk retention forms the first and last layers of the six-layer model.

Insurers are also required to retain some risk. Currently, this is the lesser of $1 million per year or 4 per cent of gross written premium for the fire and industrial special risks (ISR) class per insurer per year, with a maximum retention by the industry of $10 million per event. If the insurer does not wish to hold this level of risk the insurer may seek additional cover in the commercial market. The $1 million retention factor is not indexed. The insurer's risk retention forms the second layer of the scheme.

The ARPC charges insurers premiums in return for reinsuring the risk of claims for eligible terrorism losses. Premiums paid by insurers for reinsurance build up a pool that forms the third layer of the scheme (currently on track to reach the initial target of $300 million). The pool is currently supplemented by a bank line of credit of $1 billion provided by ABN Amro, underwritten by the Commonwealth (the fourth layer in the scheme). There is also a Commonwealth indemnity of $9 billion (the fifth layer of the scheme).

These arrangements will provide aggregate cover of up to $10.3 billion once the pool reaches the initial target of $300 million.

If the bank line of credit or Commonwealth indemnity were called on following a declared terrorist incident, it would be possible to increase the ARPC's premiums after the fact, to recoup losses and refund the bank and the Commonwealth for any outlays. For example, the Treasurer may raise the top rate charged for reinsurance from 12 per cent to a maximum of 36 per cent and the bottom rate from 2 per cent to 6 per cent, in order to ensure that the ARPC can rebuild the pool and repay the line of credit and indemnity. In that regard, the Ministerial power of direction in section 38 of the Act, that allows the Treasurer to set the premiums, also includes the power to require the ARPC to pay money to the Commonwealth. Any such Ministerial direction is a legislative instrument for the purposes of the *Legislative Instruments Act 2003*.

Operation of the Australian Reinsurance Pool Corporation

Since its inception, the ARPC has undertaken an extensive public awareness campaign to ensure that all insurers are aware of the scheme and their obligations under it and to offer reinsurance contracts to all those insurers who write eligible insurance contracts. The public awareness campaign includes initiating and maintaining contact with industry bodies, delivering presentations and addresses to industry bodies and individual insurers and conducting a targeted advertising campaign both in Australia and overseas.

The establishment, functions and powers of the ARPC are set out in Part 3 of the Act. The ARPC's main function is to provide insurance cover for eligible terrorism losses.[26]

26 Section 10.

The Act provides for an independent Board consisting of a chairperson and between 4 and 6 members. The Minister appoints members on a part-time basis. The ARPC also has a chief executive, who cannot be a member of the Board.[27]

The ARPC is subject to the requirements of the *Commonwealth Authorities and Companies Act 1997*. As a result, Board members must comply with strict corporate governance obligations. The Australian National Audit Office must audit the ARPC's annual accounts.

The ARPC is responsible for overseeing investment of the reinsurance premiums (used for the pool fund), the line of credit, its agreements with insurers and the processing of claims.

The ARPC has also entered into an investment management agreement with a professional funds manager that provides for the investment of part of the pool fund in areas permitted by the *Commonwealth Authorities and Companies Act 1997*.

Although the ARPC is not obliged to tender for the provision of services, it may choose to do so as a means of ensuring it obtains value for money in the provision of key services. This was the approach taken, for example, to establish the $1 billion line of credit and to select a professional funds manager.

The ARPC is not subject to income tax and the Commonwealth guarantees the payment of money payable by the ARPC.[28] Had commercial reinsurers not withdrawn from offering terrorism reinsurance in Australia, these provisions would give the ARPC a competitive advantage. To ensure that these provisions do not give the ARPC a competitive advantage once a substantial number of commercial reinsurers re-enter the market, the Treasurer can direct the ARPC to pay an equivalent amount to the Commonwealth to address the advantage.[29]

This power could also extend to a requirement to pay the Commonwealth a dividend or to allow the Commonwealth to recoup outlays if the Commonwealth indemnity is required following a declared terrorist incident.

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27 Sections 12, 13 and 24.
28 Sections 35 and 36.
29 See subsection 38(3).

The Australian Government expects the ARPC to conduct itself in a manner appropriate for a statutory authority. While the ARPC is not explicitly covered by the *Public Service Act 1999*, the Government expects the ARPC to comply with public service requirements, where possible, on matters such as employment conditions, workplace diversity and occupational health and safety.

DECLARING A TERRORIST INCIDENT AND PAYING CLAIMS

The Australian terrorism insurance scheme has a number of features. It provides reinsurance for insurance policies relating to commercial property and associated public liability claims and business interruption losses.

For the terrorism insurance scheme to apply, the insurance policy must exclude terrorism cover and the insurer must have reinsurance from the ARPC.

Obviously, if there is no exclusion, the commercial insurer provides the cover. Under the Act, the Treasurer must declare a terrorist incident to make the insurer's exclusion ineffective. Following a declared terrorist incident, the scheme will provide cover, in excess of the maximum insurer and industry retentions, to insurers with a reinsurance agreement with the ARPC that have paid the relevant premiums.

In declaring a terrorist act to be a 'declared terrorist incident', the Treasurer would seek the views of the Attorney-General. The Treasurer's declaration would be a legislative instrument for the purposes of the *Legislative Instruments Act 2003*.

If the Treasurer considers that an event will cost the Commonwealth more than $10 billion, either by itself or when taken together with other claims on the scheme, the Treasurer must also declare a reduction percentage. This would have the effect of limiting the level of cover, by reducing the amount payable by the insurer to the policyholder.

Given that early estimates of insured losses from disasters are frequently unreliable, if the terrorist incident is of a substantial scale it is likely that the Treasurer would initially declare a significant reduction percentage. If actual losses are shown to be less than initially anticipated, the Treasurer may reduce the reduction percentage, allowing the insurer to make an additional payment to the policyholder.

These features of the scheme necessarily mean that, in the event of a terrorist incident, insurers will not pay a claim until it is clear whether it is payable (that is, whether the Treasurer has declared a terrorist incident) and, if so, how much is payable (that is, whether a reduction percentage has been set).

Once these issues are clear, the insurer would be responsible for meeting claims in accordance with its policy terms and conditions. This means the insurer's usual procedures, such as the involvement of loss assessors or its processes for making part payments, would apply to any claim it meets.

TERRORISM INSURANCE ACT REVIEW: 2006

The Australian Government established the terrorism insurance scheme as an interim measure. Its objective is to operate the scheme only while terrorism insurance cover is unavailable commercially on reasonable terms. As such, it requires the Treasurer to prepare a report that reviews the need for the Act to continue in operation at least once every three years.[30]

The Government remains committed to the scheme while it is still needed to ensure that the Australian market is able to obtain terrorism insurance cover. However, the Government also recognises the need for private sector involvement in the market to the greatest extent possible. This may involve a staged reduction in Government intervention, to encourage sufficient capacity to return.

This report was prepared as a result of a review conducted by the Treasury during the first half of 2006.

The continuing unavailability of terrorism insurance for commercial property and business interruption on reasonable terms, and recent decisions by other countries with similar schemes to continue those schemes, suggested that the review would find a need for the Act to continue in operation. For this reason, the review was 'low key', to ensure that it did not create undue uncertainty about the immediate future of the Act and the subsequent availability of terrorism insurance. However, the review also offered the opportunity to consider refinements to the scheme that might enhance its effectiveness or facilitate greater involvement of the commercial market over time.

Treasury consulted directly with key stakeholders as part of the review, including the ARPC and representatives of insureds, brokers, banks, insurers, reinsurers and relevant Government officials, such as the Attorney-General's Department and the Australian Prudential Regulation Authority. (See the Appendix for a full list of those consulted.)

30 Section 41.

INTERNATIONAL APPROACHES

INTERNATIONAL TERRORISM INSURANCE SCHEMES

Following the withdrawal of terrorism cover, the Australian Government concluded that there was a need for government intervention. A number of governments around the world reached the same conclusion and instituted government schemes.

The Organisation for Economic Cooperation and Development (OECD) recommended that its members rely, as far as possible, on private sector solutions to cover terrorism risks. However, it appears that terrorism losses are currently too unpredictable and potentially catastrophic for the private sector to fully cover them.

To help stabilise terrorism insurance markets after large-scale or frequent attacks, the OECD suggested:

- public-private partnerships (as established in Australia, France, Germany, the Netherlands, Spain, the United Kingdom and the United States); and

- a layered approach to terrorism risk coverage (to spread risk between insureds, insurers, reinsurers, a coinsurance or reinsurance pool and the government as a last resort).[31]

This is the approach taken by Australia.

While government schemes vary, they are substantially similar. In each instance, there is a level of risk retained by the insurers from a terrorist incident, with this amount shared between them according to a pro-rata

31 OECD, above n 5, 17-19.

allocation of the total loss. A pool provides cover above this retained amount, which may include layers of cover provided by commercial reinsurers (France and Germany), a mix of commercial funding and government guarantee (as in Australia) or full government cover.[32]

Austria[33]

In Austria, the Verband der Versicherungsunternehmen Österreichs (the Austrian insurance association) created the Österreichischer Versicherungspool zur Deckung von Terrorrisiken on 1 October 2002 as a purely private co-reinsurance pool. It provides protection against property damage and business interruption for industrial, commercial and private lines with a sum insured up to €5 million for each location, policyholder and calendar year. Risks with a total sum insured exceeding €5 million are covered on a facultative basis. The scheme places reinsurance of €150 million in annual aggregate in excess of a €50 million retention in the international reinsurance market. While the scheme is voluntary, almost all the insurers that are members of the Austrian Insurance Association participate in the scheme.

France[34]

Cover is obligatory in France. Since 1986, France has required insurance policies relating to property damage (including motor vehicle policies) to cover terrorism risks.

The French GAREAT is a reinsurance pool that offers protection to direct insurers if they cede the terrorism risk forming part of all qualifying policies within their portfolio and the corresponding premium. The premium is calculated as a percentage of the total premium collected by the insurer on the insurance policies they provide. Pool membership is not compulsory.

If the sum insured is under €6 million, the insurer cannot cede it to GAREAT. If it is between €6 million and €20 million the insurer is required to cede 6 per cent of the premium to GAREAT. If the sum insured is between €20 million and €50 million the insurer must pass on 12 per cent of the

32 Bruce Thomas 'Terrorism — exposures, insurability, pools and other solutions' (Paper presented at the Institute of Actuaries of Australia XVth General Insurance Seminar 16-19 October 2005 © Bruce Thomas, Swiss Reinsurance Company). <http://svc012.wic020p.server-web.com/PublicSite/pdf/2005/GISeminar/gipaper_thomas0510.pdf >

33 OECD, above n 5, 94-9, 242-3.

34 Ibid, 94-9, 243-7.

premium. Finally, if the sum insured is above €50 million, the insurer must pass on 18 per cent of the premium received.

The pool protects medium and major risks based on a commitment by reinsurers to provide sufficient market capacity for all property risks, including homeowners' risks and other commercial risks.

GAREAT has four-layers, with the first layer provided by a co-reinsurance pool up to a limit of €400 million. If an incident occurs, the first €400 million must be covered by the co-reinsurance pool. This would see contributions from all direct insurers meeting claims in proportion to their market share. The second layer is purchased in the commercial insurance and reinsurance markets. In 2005, this second layer covered from €400 million to €1,600 million. A third layer of reinsurance, up to a limit of €2,000 million, was led by Hannover Re. The point at which this layer ended rose from €1.5 billion in 2002 to €1.75 billion in 2003. Above this layer, the French government acts as reinsurer of last resort, offering unlimited protection through the Caisse Centrale de Réassurance, a French state-owned reinsurer.

Germany[35]

Germany established Extremus Versicherungs-AG in September 2002 in response to the 11 September 2001 terrorist attacks in the United States. It is a specialist insurer with a share capital of €50 million writing only large property risk against terrorism. It benefits from a limited participation by the German government.

Extremus offers insurance coverage against property damage and disruption of business operations following a terrorist attack (as long as the business interruption was connected to property damage).

Coverage of terrorist risk is optional and membership of Extremus is voluntary. Extremus provides cover for terrorism risks in return for premiums, calculated as an amount between 0.25 per cent and 0.88 per cent of the sum insured. Extremus will only take on risk where the sum insured is over €25 million.

Insurers and reinsurers domiciled in Germany would cover the first €1.5 billion in losses, should a terrorist incident occur. International reinsurers would provide a further €0.5 billion. A €8 billion government guarantee would cover losses greater than €2 billion. As such, the scheme provides €10 billion in cover each year.

35 Ibid, 94-9, 247-9.

In 2002 and 2003, insurers and reinsurers were required to retain €3 billion in risk, before the government guarantee cut in. This retention was reduced to €2 billion in March 2004.

The government guarantee underpinning the scheme was to expire on 31 December 2005. In 2005, the German Ministry of Finance renewed it for a further two years, until 31 December 2007.

Netherlands[36]

The Nederlandse Herverzekeringsmaatschappij voor Terrorismeschaden, established in 2002, is a dedicated reinsurer writing terrorism risks in the Netherlands. For property and business interruption, there is a sub-limit of €75 million for any one policyholder or location each year, for all participating insurers. Insurers would bear a combined retention of €7.5 million or 2.5 per cent of gross premium each year, with a minimum of €50,000 per participant. If claims would otherwise exceed €1 billion in a year, the government can scale back all claims proportionately, to stay within that limit.

Spain[37]

In Spain, terrorism is one of a number of 'extraordinary risks'. Cover for extraordinary risks, including terrorism risks, is available from the Consorcio de Compensación de Seguros (CCS), a state-managed fund that provides compensation for losses that the private reinsurance market will not cover. Cover is mandatory for certain classes of insurance, including property, motor vehicle damage, theft, machinery breakdown, information technology, construction and assembly, business interruption and personal accident.

The CCS provides cover where terrorism risk is not covered privately. CCS also acts as a warranty fund when a private insurer can no longer fulfil its obligations (following insolvency, for example). An unlimited state warranty will support CCS if losses are above its own capacity for payment, although this has not yet been necessary.

The CCS charges a premium for providing cover. The applicable rate depends on the insurance policy. The premium for motor vehicle policies is based on the vehicle, for civil works it is 0.034 to 0.195 per cent of the sum insured and for individuals it is 0.00096 per cent of the sum insured. For property damage, the rate depends on the type of property insured. For homeowners the rate is

36 Ibid, 94-9, 249-253.
37 Ibid, 94-9, 253-5.

0.009 per cent of the sum insured, for buildings it is 0.014 per cent, for commercial property it is 0.018 per cent and it is 0.025 per cent for industry property. There is a rate of 0.025 per cent of the sum insured for business interruption policies.

The insurer can deduct a 5 per cent administration charge before passing on the required premium.

There are no insurer retentions under the scheme.

United Kingdom[38]

Pool Re is a mutual reinsurer in the United Kingdom, authorised to cover losses resulting from an act of terrorism, as defined by legislation.

Insurers are required to provide terrorism cover under certain insurance policies, where an insured requests such cover. An insurer can then reinsure this risk with Pool Re.

Pool Re covers commercial property, business interruption and related classes, including residential property in commercial ownership. Types of property eligible for reinsurance under the scheme are buildings and contents, engineering, contractors and computer risks, business interruption, loss of rent and book debts. While Pool Re does not cover household property owned by individuals, household policies in the United Kingdom do not necessarily exclude terrorism.

Since 1993, Pool Re has funded losses totalling £612 million, not counting losses from the terrorist bombings on 7 July 2005.

Coverage is optional, but the United Kingdom's history of terrorist attacks and the scheme's affordability mean that many firms buy cover. The scheme's members are insurers and Lloyd's syndicates authorised in the United Kingdom or by an overseas regulatory authority to transact property insurance in the United Kingdom. The United Kingdom government acts as lender of last resort for Pool Re, with a retrocession agreement to provide funding in the event that Pool Re exhausts all its financial resources following claim payments.[39]

Insurers pay a premium to Pool Re for coverage under the scheme. Reinsurance is provided at stipulated rates.

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38 Ibid, 94-9, 255-260.

39 *Wikipedia* 'Pool Re'. <http://en.wikipedia.org/wiki/Pool_Re>

Insurers are required to retain risk under Pool Re. Individual insurer retentions are based on the market share of the insurer. Industry-wide retentions also apply.

In 2003, industry wide retentions were set at £30 million per event and £60 million per year. These retentions were increased to £50 million and £100 million in 2004, £75 million and £150 million in 2005 and £100 million and £200 million in 2006.

After the retentions have been met, losses arising from a terrorism incident would be covered by the funds in the pool and then the United Kingdom government.

Pool Re cover extends to risks insured in England, Wales and Scotland, excluding the territorial seas.[40]

United States[41]

The United States' Terrorism Risk Insurance Act of 2002 (TRIA) requires insurers to make cover available for losses arising from an act of terrorism, in certain lines of commercial property and casualty insurance policies. The United States government offers a post-funded backstop facility to limit private sector exposure.

Insurers are required to offer terrorism cover to all commercial insureds. However, it is optional for the insured to purchase cover (although state law may mandate cover, in relation to workers' compensation, for example).

Liability for terrorism cover remains with private insurers unless the Secretary of the Treasury, the Secretary of State and the Attorney-General certify the event as an 'act of terrorism', if it meets a number of other requirements specified in the Act. Conditions for certification include that the act caused more than $5 million in losses and that it was not a domestic act of terrorism.

Where an incident is certified, the United States government will cover losses above insurer retention levels, set as a percentage of the insurer's direct earned premium written the previous year. In 2003, insurer retentions were set at 7 per cent of an insurer's direct earned premium over the previous year. However, the government increased these in 2004 to 10 per cent and to 15 per cent in 2005.

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40 PartnerRe *Terrorism insurance – pools and market solutions in Europe*, 12. <http://www.partnerre.com/pdf/TerrorismInsurance.pdf>

41 OECD, above n 5, 94-9, 260-4.

Insurers are liable for the incident up to this annual deductible, after which the United States government is responsible for paying 90 per cent of the insurer's losses.[42] The law provides for mandatory recoupment of payments below an industry-wide aggregate figure through a surcharge on all policyholders.

In 2003, industry wide maximum retention amounts were set at $10 billion. They were raised to $12.5 billion in 2004 and $15 billion in 2005.[43]

TRIA was to end on 31 December 2005. However, Congress passed the Terrorism Risk Insurance Extension Act of 2005, in December 2005. This amended TRIA and extended it for a further two years, until 31 December 2007.

COMPARISONS

In short, the Australian, French and United Kingdom schemes create a reinsurance pool into which reinsurance premiums are paid and from which claims are paid (including the additional support provided by the government as insurer of last resort). This mutualises the risk and moderates the risks retained by the insurance firms. In contrast, because the United States' TRIA scheme does not create a pre-funded pool, it requires the insurers to generate their own mechanisms for risk sharing. This will be positive, if it allows the private markets to develop efficient mechanisms for risk sharing, or negative, if private markets cannot develop risk-sharing structures for terrorism risk.[44] The United States has already found it necessary to extend the operation of TRIA to 2007.

Key features of Australia's terrorism insurance scheme are consistent with the 'best practice' model supported by the OECD. Suggested areas of good practice for terrorism insurance schemes include:

Timescale: take account of the long term, rather than adopt a 'quick fix';

Flexibility: allow for flexibility and provide scope for modification to match both the actual level of threat and market conditions, present and future;

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42 Wharton Risk Management and Decision Processes Center, The Wharton School, University of Pennsylvania, *TRIA and beyond: terrorism risk financing in the US*, August 2005. <http://knowledge.wharton.upenn.edu/papers/1299.pdf>

43 Thomas A Player and Anthony C Roehl 'Insuring global terrorism risks'. <http://www.mmmlaw.com/articles/article_213.pdf>

44 OECD, above n 5, 73-4.

Balance: adopt a balanced and proportionate approach, assigning an appropriate role to the insurance industry, financial markets and (where relevant) the government as insurer/financier of last resort, and taking account that the balance between these may ebb and flow depending, for instance, on the availability of capital in the insurance market and financial markets;

'Crowding out': avoid institutionalising a role for government that 'crowds out' competition from the private sector and discourages adaptation in insurance markets or limits the attractiveness of insurance markets for new investment; and

Externalities: take account of the wider economic costs of insufficient cover and hazards such as business interruption, economic instability and discouragement of investment and wealth creation that may result from such wider economic costs.[45]

Australia's terrorism insurance scheme meets these OECD criteria in a number of ways. For example, in relation to its timescale, while Australia's terrorism insurance scheme is subject to review, it has no sunset clause (unlike the schemes set up by Germany and the Unites States, which were subsequently extended). Also, many components of the scheme are readily modifiable, including the classes of insurance for which insurers are required to provide terrorism risk cover. Through its layers, the scheme distributes the cost of terrorism cover between policyholder, insurers and the Government (and thus to taxpayers), to achieve a balanced and proportionate approach. The scheme encompasses both commercial property and business interruption losses because of their importance in encouraging investment and wealth creation.

45 Ibid, 264-5.

NEED FOR THE TERRORISM INSURANCE ACT

REDUCED AVAILABILITY AND AFFORDABILITY OF INSURANCE

The primary purpose of this report is to review the need for the *Terrorism Insurance Act 2003* (the Act) to continue in operation.

The Act established Australia's terrorism insurance scheme because there was, at the time, a large pool of assets uninsured for terrorism risk. The uncertainty facing financiers and investors had the potential to delay the commencement of investment projects and to alter portfolio management decisions, with consequent adverse economic impacts more broadly for Australia. The Government therefore established the terrorism insurance scheme to provide the insurance withdrawn by commercial insurers. The scheme is an interim measure. The Government intends the scheme to operate only while terrorism insurance cover is unavailable commercially on reasonable terms; hence the requirement to review the need for the Act to continue in operation at least every three years.[46]

Before the 11 September 2001 attack on the World Trade Center, most insurers implicitly included insurance against terrorism in their contracts, as part of their general property 'all-risks' cover. The market for 'stand-alone' terrorism cover was a market of last resort. Most companies would prefer their property 'all-risks' insurers to cover terrorism, either with an extension for terrorism or by not excluding terrorism. Stand-alone cover can appear expensive, when compared to the cost of property all-risks cover. However, stand-alone markets can fill the gaps left by property all-risks insurers. To an extent, this is what occurred following the exclusion of terrorism cover from property all-risks cover.

After 11 September 2001, there was a shortage of affordable insurance cover for acts of terrorism for individuals and properties. Insurers increased their premiums sharply and wrote contracts that were more stringent.

46 Section 41.

The market has softened since. It is possible to attribute some of this to the presence of government solutions, such as Australia's terrorism insurance scheme. However, where terrorism insurance cover is available, it is expensive and many restrictions apply, which in effect means it is only available in quite limited circumstances.

Financial markets have shown little appetite for covering terrorism risks. There is no expectation that they will increase market capacity substantially in the short term, although they may provide additional capacity in the future.

In some countries with a history of terrorism losses, such as Spain and the United Kingdom, the terrorism insurance scheme is permanent. In other countries, including the United States, France and Germany, the scheme has a sunset clause. There is an argument that the Australian terrorism insurance scheme should be permanent, because the threat of terrorism is permanent. However, it was not the threat of terrorism itself, or the insertion of terrorism exclusion clauses in insurance contracts, that led the Australian Government to establish the scheme to provide the reinsurance withdrawn by commercial reinsurers. Instead, the Government acted because the absence of terrorism cover was threatening to delay investment projects and to alter portfolio management decisions, with consequent broader economic impacts for Australia. Permanent government subsidised reinsurance would remove any incentive for the private sector to develop alternative risk transfer mechanisms. Over time, the scheme should implement measures to encourage financial innovation by the private sector.[47]

EFFECTS OF 11 SEPTEMBER 2001 ON INSURANCE

There are a number of reasons for the reduced availability and affordability of terrorism cover.

The 11 September 2001 destruction of the World Trade Center caused insured losses estimated at around US$40 billion, including US$21 billion in property and business interruption lines.[48] This loss was many times greater than the insured losses from any previous terrorist incident.

47 Prof Dwight M Jaffee and Prof Thomas Russell 'Should governments support the private terrorism insurance market?' (Paper prepared for WRIEC conference, Salt Lake City, August 2005), 11-12. <http://faculty.haas.berkeley.edu/jaffee/Papers/DJTRSLCPaper.pdf>

48 OECD, above n 5, 109.

Terrorist act	Year	Insured loss (excluding liability and life)[49]
World Trade Center, New York	2001	US$19 billion
Bomb, London	1993	US$907 million
Car bomb, Manchester	1996	US$744 million
World Trade Center, New York	1992	US$725 million
Bomb, London	1992	US$671 million[50]

The destruction of the World Trade Center changed the insurance industry's approach to terrorism risk cover significantly.

First, it raised questions about the ability of insurers to spread their risk globally. Terrorism insurance is difficult to limit geographically because terrorist acts can take place anywhere at anytime, repeatedly.

Second, the concentration of risk in commercial high-rise buildings meant that what had previously been seen as being among the best insurance risks was now seen, using total loss scenarios, as high risk.

Third, the insurance exposure from the destruction of the World Trade Center coincided with a capital markets downturn and low interest rates, together emphasising how underwriting, investment and credit risks correlate.[51] (In the two years after 11 September 2001, insurers lost more from falling stock and bond markets than they paid out on insurance claims for terrorism losses. Estimates of their losses vary but are in excess of US$75 billion; that is, nearly twice the insured losses of US$40 billion of 11 September 2001.)[52]

The industry also saw the correlation of exposure across several lines of insurance arising from the same event in a new light.[53] The destruction of the World Trade Center caused multi-class accumulation, with losses in individual life, group life, aviation, property, business interruption, worker's compensation and accidental death. It demonstrated that another major terrorism event would also be likely to affect several insurance lines simultaneously.[54]

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49 Insured property indexed to 2001.
50 OECD, above n 5, 109.
51 Richard Ericson 'Catastrophe risk, insurance and terrorism' *Risk & Regulation* 2004. <http://www.lse.ac.uk/resources/riskAndRegulationMagazine/magazine/catastropheRiskInsuranceAndTerrorism.htm>
52 Thomas, above n 32.
53 Ericson, above n 51.
54 Dubois, above n 9, 5.

Given their new appreciation for the risks posed by terrorism, reinsurers, who were liable for a large proportion of the claims, were unwilling to renew coverage to insurers. Those that continued to market policies charged high rates for limited protection.

Some insurers sought to profit from the uncertainty, with an estimated US$30 billion of new capital flowing into catastrophe underwriting from venture capital in the months following 11 September 2001. Aon, an international broker of insurance and reinsurance, notes that in the following nine-month period the market grew substantially, with several new entrants. The largest was Axis Specialty in Bermuda, which provided new capacity of up to US$100 million for each risk. Capacity for stand-alone terrorism cover also increased in Lloyd's of London. For example, high rates and strong demand attracted Berkshire Hathaway to the market, to offer US$500 million of capacity per risk. This capacity was greatly needed and provided the only source for some major buyers.[55]

Aon also notes that the withdrawal of terrorism cover from all-risks policies led to greatly increased demand for stand-alone terrorism cover. This in turn allowed insurers offering stand-alone cover to pick their risks carefully. In the hardening insurance markets, insurers increased their premiums sharply and wrote more stringent contracts that put preventive security requirements on the policyholders.[56]

Despite this influx of more expensive and more limited stand-alone terrorism cover, these changes meant there was a shortage of affordable insurance cover for acts of terrorism for individuals and properties post 11 September 2001. While prices for terrorism risk later began to stabilise, subsequent attacks — such as those in Indonesia in 2002 and 2005, in Madrid in 2004 and in London in 2005 — re-emphasised the potential size of global terrorism risk.

GLOBAL TERRORISM INSURANCE MARKET

There is a range of views on the current capacity of the market to absorb terrorism risk, but there is a good deal of consistency. It appears that financial markets have shown little appetite for terrorism risk and are not expected to increase market capacity substantially in the short term, although they may provide additional capacity in the future. However, there are a number of indications of commercial insurer interest in the provision of terrorism cover.

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55 Aon Limited *Stand-alone terrorism insurance market update* March 2006. <http://www.aon.com/uk/en/pdfs/standalone_terrorism.pdf>

56 Ibid.

Aon notes that the market has softened somewhat since 2001. It attributes some of this softening to the loss of business to government solutions and pools.

According to Aon, a substantial stand-alone terrorism market has developed since 11 September 2001. While the property all-risks insurers are unwilling to offer terrorism coverage, Aon suggests that the stand-alone market has sufficient capacity to fill most gaps in property insurance, at a price.

In 2004, the stand-alone market had about US$1.2 billion in capacity to cover terrorism risks, according to Aon.[57] In mid-2005, Marsh (another international broker) estimated terrorism market capacity outside of major metropolitan areas at approximately $1.4 billion.[58] Aon's later measurement in March 2006 put market capacity at around US$1.3 billion.[59]

Lloyd's European Risk Forum in November 2005 identified terrorism as a key risk for the insurance industry, although it was no longer an emerging risk. A terrorism underwriter at Lloyd's said that the amount of terrorism capacity had steadily increased since 11 September 2001, making cover readily available.[60] He suggested that the market was becoming increasingly competitive, as insurers sought to balance their risk portfolio following the hurricane season in the United States. He said that insurers with large amounts of natural catastrophe and earthquake cover were considering terrorism cover as a way to broaden their risks classes, as it is a significantly different type of risk to the natural catastrophe business.[61]

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57 'Critics say U.S. shouldn't renew terrorism insurance. Federal terror insurance under fire' *CBS MarketWatch* 11 September 2004. <http://www.alwayson-network.com/comments.php?id=P5835_0_6_0_C>

58 Marsh *Marketwatch: Terrorism Insurance 2005*, 2. <http://72.14.209.104/search?q=cache:hVzynTr71hoJ:www.marsh.dk/files/Marketwatch_Terrorism_Insurance_2005.pdf+&hl=en&gl=au&ct=clnk&cd=5>

59 Aon, above n 55.

60 Lloyd's News Centre 'Terrorism and climate change top of mind in Europe' 10 November 2005. <http://www.lloyds.com/News_Centre/Features_from_Lloyds/Terrorism_and_climate%20change.htm>

61 Lloyd's News Centre 'Competition increases in terrorism cover as threat continues' 4 January 2006. <http://www.lloyds.com/News_Centre/Features_from_Lloyds/Competition_increases_terrorism_cover.htm>

Aon points out that the insurance of risks located in capacity 'hot spots' is an exception to this softening market. Certain cities have become terrorism capacity hot spots. For example, insurance capacity is very limited in midtown and downtown Manhattan, and in Brussels, and this has driven up prices. In some areas, demand is so great that the insurers can sell whatever capacity they have left at high rates.[62]

Marsh also notes that the amount available for a specific risk can vary significantly, depending on the risk's location, the insurer's accumulated exposure and the concentration of exposures in the given area. It suggests that, in major metropolitan areas with high levels of concentrated risk, the terrorism market capacity is more limited and much more expensive.[63]

Also, insurers may apply restrictions to 'trophy' buildings, sports stadiums, entertainment theme parks and transportation hubs, vulnerable to terrorism.[64]

With the exception of the hotspots, Aon considers that overall rates for stand-alone terrorism insurance have dropped by 40 to 50 per cent from 2002 to 2005. A steady growth in capacity and a favourable claim-to-premium ratio has led to increased competition and premium reductions.[65]

Aon considers premium rates to have become much more predictable from 1 January 2006, with reductions of 5 to 15 per cent for renewals on many risks.[66] While the softening in the reinsurance market means that stand-alone insurers and property all-risks insurers are able to buy some cover, Aon still views the market as being restrictive:

- capacity is much less than for property all-risks policies that exclude terrorism;
- reinsurers generally require direct insurers to take large retentions for each event;
- there is very little quota share capacity, as reinsurance is structured mostly as 'excess of loss';
- pricing is relatively high;

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62 Aon, above n 55.
63 Marsh 2005, above n 58.
64 Aon, above n 55.
65 Ibid.
66 Aon Limited Media Centre 'Steady drop in rates and increasing demand fuel stand-alone terrorism insurance market' 5 April 2006. <http://www.aon.com/uk/en/about/Press_Office/standalone_terrorism.jsp>

- the availability of cover for property insurers depends greatly upon the type of risks they write and the domicile of the direct insurer; and
- reinsurers closely monitor aggregate exposures.[67]

Marsh considers capacity in the stand-alone property terrorism insurance marketplace to be relatively stable, though limited.[68] Aon argues that lack of reinsurance capacity at affordable prices has been a significant barrier to entry into the stand-alone market. For example, Berkshire Hathaway has considerable available capacity and has written some large global terrorism reinsurance programmes. However, it requires a premium for its 'AAA' paper that many direct insurers have not found to be affordable.[69]

Aon notes that the series of hurricanes in 2005 will also affect property reinsurance renewals. The reinsurers selling this property reinsurance are the same group that selectively offers terrorism reinsurance, so they will be less inclined to include additional perils, such as terrorism. Some buyers may buy less cover, due to capacity and pricing constraints. However, Aon suggests that the impact on terrorism reinsurance will be less. It argues that stand-alone terrorism insurers tend to take on large net retentions and therefore rely less on reinsurance than other markets.[70]

In the United States, liability for terrorism cover for an event remains with private insurers unless it is certified as an 'act of terrorism'. It appears that there is a modest amount of reinsurance available for 'certified terrorist acts' in the United States. In 2004, only a few insurers were buying reinsurance for their deductibles or retentions, because of its high cost and because their policyholders are not buying cover. However, Marsh suggested that reinsurance for non-certified terrorism was widely available, at a reasonable cost. Most insurers bought it in both their risk and catastrophe treaties and, in turn, offered non-certified coverage to primary insurance buyers. Marsh suggested it was not clear whether that would lead to certified reinsurance as retentions increase, or when TRIA ended.[71]

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67 Aon, above n 55.
68 Marsh 2005, above n 58.
69 Aon, above n 55.
70 Ibid.
71 Marsh *Marketwatch: Property Terrorism Insurance 2004*, 38.

The expiration of TRIA in 2007 may lead to a rush on coverage from the stand-alone market, if it does not have sufficient capacity to replace TRIA. Marsh considers that the stand-alone insurance market would be unlikely to have sufficient capacity to satisfy all of the expected demand at commercially viable prices.[72] The resulting higher prices may be problematic for those wanting to buy cover, but would also attract more capacity into the market, allowing it to grow. That is, a decrease in affordability would lead to an increase in availability that would in turn lead, over time, to a subsequent increase in affordability.

AUSTRALIAN TERRORISM INSURANCE MARKET

In establishing the terrorism insurance scheme, the Australian Government considered that uncertainty in the market made it impossible to stipulate, at the time, the details or timing of its windup.

The Government made components of the scheme flexible; there is no need to change the Act to change premium rates, for example. This flexibility allows the Australian Reinsurance Pool Corporation (ARPC), established by the Government to administer the scheme, to respond to changes in market conditions. It also allows the scheme to encourage the re-entry of the commercial market.

The review found the ARPC to be well regarded by stakeholders, and to be prudent and efficient (the ratio of the ARPC's general and administrative expenses to net earned premium is under 4 per cent).

Swiss Re notes that Australia can compete against the United States and Europe in attracting the limited capital that is available for terrorism reinsurance, ranking fourteenth in terms of penetration and despite being only 3 per cent of the world insurance market. Australia is a first class insurance market. Swiss Re suggests that the size of the market is less important than the quality of information available, the quality of the risk transfer and transparency. Australia also has the advantage of being geographically distant from other centres of risk, enabling reinsurers to diversify their risk.

72 Marsh 2005, above n 58.

While the ARPC sees the market for terrorism insurance as having recovered somewhat, it suggests that the market is not yet at the stage where it has eliminated the need for the scheme. The ARPC is confident that all local insurance companies are aware of the scheme and those that have meaningful exposure have elected to reinsure with it. Four major reinsurers dominate the Australian reinsurance industry. These continue to exclude terrorism cover from their standard commercial property treaty contracts, but provide some cover for domestic policies, while continuing to exclude nuclear, biological and chemical attack.

The ARPC sees some evidence of a re-emergence of terrorism cover through:

- domestic 'write-back' on treaty reinsurance, which is passed on to the policy holder;
- the ability to purchase 'deductible buy-downs' from commercial reinsurers on the retention required by the APRC's reinsurance; and
- selected facultative terrorism cover on specific low-risk sites.

The ARPC holds, however, that there is no evidence that the reinsurance industry is offering widespread terrorism cover with meaningful capacity at a reasonable price. It suggests that the reinsurance industry will only offer terrorism cover if it feels it can control its aggregate exposure and ensure that it is not exposed to the risk of ruin from a large-scale attack. It is also unlikely that reinsurers will offer widespread capacity on a product unattractive to their shareholders.

The Insurance Council of Australia (ICA) understands that the withdrawal of terrorism cover continues. It suggests that, where it is possible to obtain cover, it is expensive and only available in isolated cases. The ICA considers that the need for the Act and the ARPC remains.

The Property Council of Australia notes that there was a significant market failure when the scheme was established and — based on information from brokers and insurers — there is still considerable market failure in insurance for terrorism risks. It is concerned that terrorism cover would not be obtainable without the scheme, particularly if a terrorist incident occurred. It suggests that the Act is vital to the long-term financial protection of Australia's property sector and those who rely on it, and that it should continue for the foreseeable future.

The Property Council shares the view that there is no indication that the market is coming back. While this may change in time, it sees this as being unlikely in the near future. The Property Council also notes that the introduction of the scheme resulted in significant savings, with premiums for some members reduced by 80 per cent from the peak reached following 11 September 2001. This suggests that, without appropriate modifications over time, the scheme could be a barrier to the re-entry of the commercial market.

The Australian Bankers' Association believes that the withdrawal of terrorism insurance cover continues. It suggests that, where terrorism insurance cover is available, it is expensive and many restrictions apply, which in effect means it is only available in quite limited circumstances. Similarly, Benfield sees terrorism insurance as being available on a facultative basis, but expensive.

That terrorism cover in Australia is expensive is explained by the American International Group, which notes that premiums are high because only those entities that consider themselves to be exposed to terrorism risk choose to take out insurance. High premiums are the insurer's way of avoiding adverse selection (where those who take out insurance are more likely to make a claim).

Aon notes that a rise in property values could put budgetary pressure on those purchasing stand-alone terrorism cover. However, secured lenders in real estate continue to require commercial borrowers to buy full terrorism coverage. While loan agreements drafted before 11 September 2001 were usually vague or silent on the need for terrorism insurance for the mortgaged property, new loan agreements tend to require cover.[73]

It would also be difficult to reduce cover, despite its expense, given corporate governance requirements contained in the *Corporations Act 2001* and applied to listed companies by the Australian Stock Exchange, whose principles of good corporate governance and best practice recommendations include a principle of recognising and managing risk. This includes management completing an annual review of all insurance requirements and negotiating appropriate insurance arrangements, with the board reviewing the insurance arrangements and approving any changes. Additionally, trustees have fiduciary duties developed from the common law and may also be subject to specific obligations, such as those in the *Superannuation Industry (Supervision) Act 1993*.

73 Aon, above n 55.

Aon suggests that the return of private sector underwriting is likely to be gradual. Other jurisdictions and their solutions will indicate how this might develop. For example, a number of countries other than Australia, including France and Germany, have a pool solution that includes a mix of private and public sector backing. The reinsurance cover for the pools is layered, with private sector reinsurers providing tranches of cover and the state providing the ultimate layer. Aon suggests that the ARPC could replace the existing line of credit and part of the government guarantee with layers of privately placed reinsurance. However, the viability of this proposal is unclear. Aon also indicates that it would be unlikely for the Government not to be the reinsurer of last resort, providing protection against an apocalyptic event. Governments in other jurisdictions currently occupy this role.

Lloyd's of London has noted that there are opportunities for insurers to provide terrorism cover in Australia. First, insurers can provide terrorism cover in respect of risks to the extent that they are not covered by the Act. Second, insurance can provide top-up cover over and above the reduction percentage. In the event of a declared terrorist incident, the Treasurer may declare a reduction percentage. The reduction percentage reduces the payout by the insurer. Therefore, this may reduce the payout for a terrorist event significantly. For example, if a destroyed building was insured for $1 billion and the reduction percentage was set at 30 per cent (because of the total extent of the destruction), the building owner would have a $300 million shortfall, which top-up insurance would meet. Third, there is a potential for policyholders to require cover that (depending on the risk to be covered and the postcode location of that risk) an insurer may be able to price more cheaply than a policy reinsured with the ARPC.[74]

CONTINUED NEED FOR GOVERNMENT INVOLVEMENT

Government involvement in terrorism insurance has two main benefits. It ensures that terrorism insurance is available and it lowers the price relative to the insurance industry's assessment of its actuarially fair value.

Australia prevents insurers from excluding terrorism risk from insurance for commercial properties. Where cover is voluntary, rates for the take–up of terrorism insurance can be low. At the end of 2004, only about half the companies in the United States bought insurance, while in Germany less than 3 per cent of eligible firms took up its compensation scheme.

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74 Lloyd's 'Frequently asked questions', 4. <http://www.lloyds.com/NR/rdonlyres/8AB3B702-577C-4507-9C4B-0D3DB57538DB/0/FAQNov2005.pdf>

Because capital lenders are unwilling to self-insure, Australia's terrorism insurance scheme supports debt finance in a number of industries, most notably commercial construction. If the Government did not make terrorism reinsurance available through the ARPC, debt-financed construction projects would not go ahead. Developers who require debt financing must still buy terrorism insurance, even if the insurance is only available for a high premium.

Construction is not the only industry that benefits from readily available and affordable terrorism insurance. Any commercial activity likely to be a terrorist target benefits, including transportation, sports and tourism.[75]

Other jurisdictions recognise the continued need for government involvement in terrorism insurance. In the United States, TRIA was to end on 31 December 2005. However, Congress passed the *Terrorism Risk Insurance Extension Act of 2005*, in December 2005. This amended TRIA and extended it for a further two years, until 31 December 2007. Similarly, the German government guarantee underpinning the Extremus Versicherungs-AG was to expire on 31 December 2005 but has been renewed for a further two years, until 31 December 2007.

The American Academy of Actuaries suggests that a national framework for terrorism risk is necessary for the United States, if terrorism coverage is to be widely and readily available.[76]

Insurers argue that the characteristics of terrorism risks make its insurability by the private sector alone very problematic, including:

- the potential for catastrophic losses;
- that catastrophe insurance lines (including terrorist risks) require access to large pools of capital if the insurer is to avoid a significant risk of ruin;
- uncertainty about the probability and potential severity of losses, as actuarial methods using historical data and data-based models are not available for terrorist insurance; and

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75 Thomas Russell 'The costs and benefits of the Terrorism Risk Insurance Act: A first look' (Paper submitted to the NBER Insurance Conference November 2002), 10.

76 Lloyd's News Centre 'Insurance industry cannot manage terrorism risks alone' 16 May 2006. <http://www.lloyds.com/News_Centre/Features_from_Lloyds/Insurance_industry_cannot_manage_terrorism_risks_alone.htm>

- the existence of interdependent risks, such as a building, damaged by a bomb, collapsing on another building that was not a direct target.[77]

Inability to measure exposures and assess accumulations is a major concern of insurers. Since 11 September 2001, insurers have sought to improve their analysis of the risks and scope of cover.[78] The United States Treasury considers that the ability of insurers to model terrorism events has improved and that this allows insurers to more accurately assess their accumulation risks, project the impact of an event and quantify the amount of reinsurance protection required to protect their surplus and security ratings.[79]

While terrorism risk modelling has improved, it is yet to make the likelihood of future attacks more predictable. It is more subjective and less reliable than the modelling of other large risks.[80]

Reinsurers can partially address the imprecision in the probabilities of a terrorist attack by setting a premium that compensates them for the uncertainty surrounding the estimates of the probability of loss. In short, they charge more. For example, reinsurers underwrite many large risks (such as earthquake losses in California), despite their probability assessments falling within very broad bands.[81]

As the losses from 11 September 2001 demonstrated, the multi-class accumulation that occurs with all-risks cover from a terrorist act can be very large. As a result, a blanket removal of terrorism exclusions is unlikely.[82] This suggests that only stand-alone terrorism risk insurers will provide significant levels of cover in the foreseeable future, rather than property all-risks insurers.

Insurers argue that terrorism insurance is not yet sufficiently widely available and affordable for Australia's terrorism insurance scheme to end.

Limited commercial terrorism-related insurance cover is now available for commercial property and business interruption. Where cover is available, it is at a price that may exceed what the policyholder may see as being the true cost

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77 Wharton Risk Management and Decision Processes Center, above n 41.

78 Thomas, above n 32.

79 United States Department of the Treasury *Assessment: The Terrorism Risk Insurance Act of 2002* 30 June 2005, 6. <http://www.treas.gov/press/releases/reports/063005%20tria%20study.pdf>

80 Wharton, above n 42.

81 Prof Dwight M Jaffee and Prof Thomas Russell 'Should governments support the private terrorism insurance market?' (Paper prepared for WRIEC conference, Salt Lake City, August 2005), 11-12. <http://faculty.haas.berkeley.edu/jaffee/Papers/DJTRSLCPaper.pdf>

82 Thomas, above n 32.

of the risk, with large excesses and relatively low maximum coverage, particularly when compared to the market cover previously available.

It does not appear likely that an adequate supply of terrorism risk insurance will return in the short to medium term in either the domestic or global markets at a reasonable price.

CONCLUSION

In short, there is still a need for the Act to continue in operation. Given the cyclic nature of insurance and reinsurance, ongoing monitoring for changes is required. As such, the Act will be reviewed again in no more than three years. It would be desirable for that review to consider any action by comparable countries to continue, or wind up, overseas terrorism insurance schemes.

To avoid crowding out the commercial market there is a need to encourage private sector involvement, to the greatest extent possible. This would allow the Government to withdraw once terrorism risk cover is available commercially on reasonable terms.

This is not just a question of complete withdrawal versus the status quo. There may be a range of options for either encouraging sufficient capacity to return through a staged reduction in Government intervention, or through ongoing Government intervention. The next review of the scheme could consider options for a staged reduction in Government intervention.

The reinsurance industry is focused on accurate pricing of its products and quantifying its aggregate exposure to different types of perils. Consistent with the approach overseas, it is important for the ARPC to develop the capability to understand its overall risks and to accurately report on its aggregate exposure within each of its three premium tiers, if it is to encourage reinsurers back into the terrorism reinsurance market. It can use accurate exposure data to entice reinsurers to offer some terrorism cover. The ARPC should also do what it can to encourage greater private sector involvement in terrorism insurance. However, it is unlikely that adequate capacity for the Australian market will be available in the near future.

Recommendation

That the Act continues in operation, subject to a further review in no more than three years.

REFINING THE SCOPE OF THE SCHEME

INTRODUCTION

The primary purpose of this review is to determine whether the *Terrorism Insurance Act 2003* (the Act) needs to continue in operation.

However, the review also presented an opportunity to consider the operation of the scheme and to determine whether refinements may be warranted in the event that the review found the scheme remained necessary.

Key stakeholders were invited to provide comments on all aspects of the scheme and some suggested changes to its scope. Specifically, concerns were raised about the exclusion of:

- commercial insurance for certain public authorities, such as local water utilities;
- commercial insurance for residential property, especially high-rise residential buildings; and
- discretionary mutual funds (DMFs).

This chapter considers whether, three years since its commencement, there is a need to refine the scope of the scheme to minimise any detrimental economic impacts that may have arisen as a result of any further withdrawal of terrorism risk cover. A secondary objective is to ensure that the scheme applies consistently to all commercial property and infrastructure that was originally intended to benefit from the scheme.

After restating the existing scope of the scheme, this chapter considers, in turn, each of the issues identified above and analyses the costs and benefits of changing the scope of the scheme to accommodate these stakeholder concerns.

Scope of the terrorism insurance scheme

The Act operates so that terrorism exclusions in eligible contracts of insurance are deemed to have no effect. In turn, insurers can reinsure any terrorism risks that the Act requires them to assume with the Australian Reinsurance Pool Corporation (ARPC).

The terrorism insurance scheme covers all 'eligible insurance contracts' applying to commercial property in Australia and associated business interruption losses and public liability claims.

The scheme covers contracts that insure:

- loss of, or damage to, eligible property that is owned by the insured;
- business interruption and consequential loss arising from loss of, or damage to, eligible property that is owned or occupied by the insured or an inability to use such property; or
- liability of the insured that arises out of the insured being the owner or occupier of eligible property.[83]

The scheme also covers insurance for major construction projects, irrespective of whether the building is ultimately used for commercial or residential purposes. However, the scheme does not generally cover insurance relating to residential property, including builders' warranty insurance or home owners' warranty insurance.[84]

Insurance relating to property owned by government business enterprises (GBEs) and local governments is covered by the Act, while buildings or infrastructure owned by State and Territory governments and the Australian Government are not.[85] Instead, State and Territory governments and the Australian Government self-insure.

INSURANCE FOR PUBLIC AUTHORITIES

The ARPC notes that there is some concern that the scheme covers commercial insurance relating to some, but not all, public authorities.[86]

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83 Subsection 7(1).
84 See items 2 and 40 of Schedule 1 of the Regulations.
85 Item 8 of Schedule 1 of the Regulations.
86 For the purpose of this discussion, a 'public authority' means a public authority of the Commonwealth, a State, the Northern Territory or the Australian Capital Territory or an instrumentality or agency of the Crown in right of the Commonwealth, a State, the Northern Territory or the Australian Capital Territory. However, it does not include the Crown in right of the Commonwealth, a State, the Northern Territory or the Australian Capital Territory or a Minister or Department of the government of the Commonwealth, a State, the Northern Territory or the Australian Capital Territory.

Issue

The scheme excludes insurance contracts underwritten by the Australian Government and State insurance. However, for thoroughness, the scheme also excludes insurance provided in relation to certain government bodies, regardless of whether they are insured commercially or by government.

The *Terrorism Insurance Regulations 2003* (the Regulations) provide that a contract of insurance that covers public authorities is excluded from the scheme, except where the public authority is a GBE or a 'local governing body established by or under a law of a State, other than a body whose sole or principle function is to provide a particular service, such as the supply of electricity or water'.[87]

Some stakeholders argue the Regulations create an anomaly in the treatment of commercial insurance for public authorities. For example, commercial insurance relating to a state owned GBE that supplies water, such as Melbourne Water, will have access to the scheme, while commercial insurance relating to a local government utility whose sole purpose is to supply water, such as the Barwon Region Water Authority, is excluded.

The example of local government utilities demonstrates an inconsistency, being that commercial insurance provided for some public authorities is allowed access to the scheme while commercial insurance for other public authorities is not.

Whether a public authority is in or out of the scheme currently depends on the insurance cover it obtains and also how the body was established and its function.

The issue is whether the scheme should apply to commercial insurance provided for all public authorities, regardless of how the public authority is established or its function.

Analysis

The scheme excludes commercial insurance for a range of public authorities despite insurance for GBEs and local government (but not local government utilities) having access. The public authorities excluded from the scheme are required to accept the risk of a terrorist incident, seek insurance from their respective governments or buy commercial terrorism insurance.

87 Items 8(d), (e) and (f) of Schedule 1 of the Regulations.

A significant proportion of public authorities take advantage of lower cost (self) insurance arrangements underwritten by their respective governments. For example, 180 entities are insured under Comcover, the Australian Government's self-managed insurance fund.

In contrast, other public authorities may obtain commercial insurance.

It is not apparent why some of these public authorities are treated differently under the scheme. In relation to local government utilities, it appears that their exclusion was unintended. (The Explanatory Statement for the *Terrorism Insurance Amendment Regulations 2003 (No. 1)* indicates that the policy intent has always been that local government property would be covered by the terrorism insurance scheme.)

Changing the scheme so that it covers commercial insurance for all public authorities would ensure consistency. A public authority would no longer have to show that it is a GBE or a local government; provided it purchases commercial insurance it would be covered by the scheme.

Also, by allowing insurance for public authorities access to the scheme, the ARPC would be able to further diversify its risk. The ARPC currently only reinsures public authorities established as a GBE or a local government.

Including commercial insurance for all public authorities in the scheme would involve some costs. Principally, the Australian Government, and thus Australian taxpayers, will be required to assume risk for all commercially insured public authorities. However, as noted above, the scheme already covers many commercially insured public authorities and the additional public authorities that would be brought into the scheme are not likely to be large in number.

If brought into the scheme, terrorism exclusions in commercial insurance policies covering public authorities will have no effect. In the first instance, insurers covering public authorities that are currently excluded from the scheme will become liable for terrorism risks. Insurers could reinsure this risk with the ARPC in return for paying 2, 4 or 12 per cent (as appropriate) of the underlying premium.

Insurers are likely to pass the costs of purchasing reinsurance onto the policyholder, which would increase the premium of the public authority.

Conclusion

The scheme does not currently treat all commercial property and infrastructure consistently. Commercial insurance relating to GBEs and local government is included in the scheme while commercial insurance relating to other public authorities is not. Allowing insurance for all public authorities access to the scheme will address this inconsistency and also help the ARPC to further diversify the risk it assumes.

Recommendation

That the scope of the scheme be extended to cover commercial insurance provided in relation to all public authorities.

INSURANCE FOR HIGH-RISE RESIDENTIAL BUILDINGS

The Australian Bankers' Association, the Insurance Council of Australia and the Property Council of Australia raised concerns about the exclusion from the scheme of high-rise buildings used solely or predominantly for residential purposes.

Issue

To determine whether an insurance policy relates to a commercial or residential building (and hence whether the Act applies), an insurer must categorise the building as one or the other. If a policy is issued in relation to a building that is predominately commercial, then that policy is considered to be an 'eligible insurance contract' under the Act. However, if a policy is issued in relation to a building that is predominantly residential, then that policy is not considered to be an 'eligible insurance contract'.

This means that the scheme excludes insurance for high-rise residential buildings and high-rise buildings used predominantly for residential purposes. Owners of such buildings must bear their own terrorism risk or seek commercial terrorism cover.

The risk of a terrorist incident affecting such high-rise buildings may be similar to the risk of a terrorist incident affecting a high-rise commercial building.

Should a terrorist incident affect a predominantly residential high-rise building, it has been argued that this may adversely impact the property market. In particular, it may be difficult for developers to sell residences in high-rise buildings following a terrorist incident, where such residences are unable to obtain terrorism cover.

To pre-empt this potential negative impact on the property market, stakeholders have suggested that insurance contracts relating to predominantly residential high-rise buildings should be included within the scope of the scheme.

Analysis

Commercial terrorism cover is available as a part of an 'all risks' policy for residential buildings, if the building has a sum insured of less than $10 million. However, such cover may exclude losses caused by more catastrophic terrorist events, such as a chemical, biological or nuclear attack.

The Government considers the withdrawal of terrorism risk cover from insurance policies as a market failure. However, whether or not some form of Government intervention is warranted depends on the effect the market failure is having on the Australian economy.

The scheme was established to cover insurance for commercial property because the withdrawal of terrorism cover was having a negative impact on the operation of the commercial property sector. As noted earlier, a survey conducted by the Association of Risk and Insurance Managers of Australasia of its 500 members in early 2002 indicated that more than 40 per cent of companies had had terrorism excluded from policies renewed after 11 September 2001 and 64 per cent of those yet to renew had been told they would not get terrorism cover.[88]

This widespread withdrawal of terrorism cover from commercial insurance policies was making it difficult for developers to obtain debt finance for large construction projects. The reduction in available finance was threatening to cause a decline in construction, which would eventually lead to a downturn in the property sector with likely flow on effects for the wider economy. The scheme provided a solution to these problems and protected the interests of commercial property owners, developers and lenders.

Also, the lack of terrorism risk cover meant that, in the event of a terrorist incident, the financial system may be at risk. This was because large

88 Parliament of Australia Parliamentary Library, above n 16.

concentrated losses to a key financial institution caused by the destruction of a debt financed but uninsured building or piece of infrastructure could lead to the institution's failure and resultant shocks to the rest of the financial system.

The current regime was structured to ensure that insurance on the construction of all high-rise property would have access to the scheme, regardless of whether such property would ultimately be used for residential or commercial purposes. It is not until the building is completed and the residences are sold that insurance on that structure is no longer considered an 'eligible insurance contract'.[89]

This arrangement means that developers are largely unaffected by the withdrawal of terrorism risk cover. Developers have been able to continue constructing high-rise residential buildings. The ability to obtain finance has not been affected, even where a lender requires the project to be insured against all risks, including terrorism. Further, the risks to the financial system are limited as the scheme covers the interests of lenders who debt finance large building projects.

When the scheme was introduced, the withdrawal of terrorism risk cover from insurance relating to residential property had not had an impact on the willingness of lenders to provide debt finance for residential purposes, for example, to buy an apartment in a high-rise building.

Lenders can diversify the risk they assume when lending for residential purposes because lenders usually provide finance in smaller parcels which can be spread over a number of different geographical locations. In contrast, when a lender provides finance for a large commercial construction project, it is often concentrating substantial funds in one venture. The lender relies on the construction project as security against default on the loan, and if that project is uninsured, then the lender is at risk.

There is no evidence to suggest that, three years since the scheme commenced, the willingness of lenders to provide finance for residential developments or apartments in high-rise buildings has declined. [90]

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89 See Item 2(d) of Schedule 1 of the Regulations.

90 ABS housing finance figures do not indicate substantial falls in the number of Australian dwellings financed from 2001 to now. However, the ABS figures do not differentiate between the types of dwellings for which finance is provided. See ABS series 5609.0 — *Housing Finance, Australia.* <www.abs.gov.au>.

As noted in the following table, according to the Housing Industry Association Economics Group, from 2001-02 to 2004-05, unit commencements (including high-rise apartments) were steady. Developers would not have started constructing new units if they considered it unlikely that they could sell them, recalling that most units are debt financed.

Unit commencements in Australia[91]

Period	Unit commencements
2001-02	47,992 units
2002-03	54,539 units
2003-04	52,331 units
2004-05	50,170 units

As such, the remaining argument supporting including predominantly high-rise residential buildings in the scheme is that, should a terrorist incident occur that impacted such a building, there is potential that the property sector could be adversely affected.

That is, it could become difficult for developers to sell residential apartments in high-rise buildings if residents were unable to obtain cover for terrorism risks. A reduction in property sales due to a terrorist incident would have a direct impact on property developers and other intermediaries in the property sector, which may lead to a slow down in the sector generally and have negative flow on effects for the wider economy. Including insurance for high-rise residential property in the scheme would pre-empt and negate the effect of this possible economic impact.

However, at this time, this potential cost does not appear to be impacting on the ability of the property sector to continue operating efficiently, nor is it causing any apparent impact on the Australian economy.

If insurance for high-rise residential buildings was allowed access to the scheme, there are a number of consequences that require consideration.

If the ARPC only reinsured insurance relating to high-rise residential property (which is considered to be a higher risk) without also assuming responsibility for lower risk residential property, the overall risk assumed by the scheme would increase. If the ARPC was unable to diversify the risk it assumed in relation to residential property, this may impact on the sustainability of the scheme.

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91 Housing Industry Association Economics Group *Dwelling Unit Commencements, Australia*. <http://economics.hia.com.au>

To diversify its risk in a manner consistent with the scheme's treatment of commercial property, all insurance relating to residential property would need to be included in the scheme. This would mean that all residential property holders in Australia that had home insurance would contribute to the scheme, whether they lived in a high-rise apartment or not. In other words, the insurance purchasing owners of 97 per cent of Australia's private dwellings would be contributing funds that are most likely to benefit the owners of less than 3 per cent of all dwellings, that is, the owners of apartments in 'high rise' residential buildings.[92]

In the financial year ending June 2005, insurers collected gross premium revenue of $3,250 million from homeowners.[93] If the scheme applied to residential property (and assuming insurers passed on the costs of reinsuring with the scheme), this would involve an increase in the premiums that homeowners were required to pay. Even understating this increase by assuming that no homeowners would be charged 12 per cent for terrorism cover, total premiums would increase by approximately $114 million.[94]

The scheme currently provides approximately $10.3 billion terrorism cover (made up of the reinsurance pool, which is initially targeted to be $300 million, a $1 billion line of credit and a $9 billion Commonwealth indemnity). If the scheme was expanded to cover additional classes of property, $10.3 billion may not be sufficient to cover all terrorism risks.

This means that there would be a greater chance that reinsurance would be insufficient to cover all insured losses if a large terrorist incident was to occur in the future. In that regard, the Act requires the Treasurer to specify a reduction percentage if the total amount payable by the Commonwealth, either for the incident itself or when taken together with other claims on the scheme,

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92 At the 2001 Census there was 198,626 flats, units or apartments in a four or more storey block (that is, a 'high rise'). At the same date, there were a total of 6,684,000 other occupied dwellings (that is, 'separate houses', 'semi-detached, row or terrace houses, town houses etc' and 'flats, units and apartments'). The 'high rise' flats, units or apartments (198,626) are only 2.86 per cent of all occupied dwellings (6,684,000 + 198,626): see table B18 in the ABS, *Census of Population and Housing: Selected Social and Housing Characteristics*, 2015.0, 2001. <http://www.ausstats.abs.gov.au/ausstats/subscriber.nsf/0/74B727D9E14BB247CA256DCC007F5048/$File/20150_2001%20(reissue).pdf>

93 Australian Prudential Regulation Authority, above n 1, 17.

94 The *ABS 2006 Yearbook* (117) indicates that at 30 June 2004, 75 per cent of the population lived in urban areas (cities with a population greater than 100,000). Accordingly, if all insurance for residential property was covered by the scheme, 75 per cent of homeowners would be charged an additional 4 per cent (or more) on their home insurance premium for terrorism cover, a total increase of at least $97.5 million. The remaining 25 per cent of homeowners would be charged an additional 2 per cent on their home insurance premium for terrorism cover, an increase of $16.25 million.

would be greater then $10 billion.[95] As such, there would be a greater chance that each claim would not be met in full.

If insurance for predominantly residential property was allowed access to the scheme, a question would also arise as to whether one or two pools would be necessary. If the existing pool was used, residential property owners would initially be covered by a pool to which they had not contributed premium. This would enable residential property owners to 'free ride' on those who had previously paid premiums that contributed to the building of the pool.

It is worth noting that if the scheme continues to exclude insurance for residential property, this does not mean that the Government could not provide assistance in a different form should a terrorist incident occur. There are a number of existing arrangements in place for dealing with disasters and emergencies. The Government also retains an ability to consider specific options for support should a terrorist incident ever damage residential property.

Conclusion

Including insurance on predominantly residential high-rise buildings would involve a transfer of cost and risk from property owners to the Government and thus to Australian taxpayers. Consistent with its approach to commercial property, for the Government to assume these risks, it must be evident that the lack of terrorism cover in this sector is having, or is very likely to have, a detrimental impact on the Australian economy. However, this is not the case. From 2001-02 to 2004-05, unit commencements (including high-rise apartments) were steady. There is no evidence to suggest that the sale of these apartments has reduced due to the withdrawal of terrorism risk cover. Allowing access to the scheme for insurance for predominantly high-rise residential buildings would impose substantial costs and would produce limited benefits.

Access to the scheme by non-insurers

The ARPC note that some businesses are concerned that the scheme does not cover insurance-like products offered by discretionary mutual funds (DMFs).

95 Section 6.

Issue

DMFs offer an insurance-like product. However, in any provision of cover to its members a DMF retains discretion as to whether or not to give protection in respect of a particular claim.

The discretionary nature of such products means that DMFs do not need to become insurers authorised by the Australian Prudential Regulation Authority under the *Insurance Act 1973*.[96]

Members of DMFs may own or occupy 'eligible property' and could potentially suffer 'eligible terrorism losses' in a 'declared terrorist incident'. However, because DMFs do not issue 'eligible insurance contracts', the Act does not apply.

If a member of a DMF suffered an 'eligible terrorism loss' and there were terrorism exclusions in the cover offered by the DMF, the 'eligible property' would be without cover unless the DMF member had arranged alternative commercial insurance cover for terrorist incidents.

The issue is whether insurance-like products, such as those offered by DMFs, warrant coverage under the Act.

Analysis

To the extent that DMFs are excluding terrorism risks from their contracts, members of DMFs are at risk if they have not arranged for commercial cover for terrorism risks. Should a terrorist incident occur that affected property owned by DMF members, those members would incur all of the losses.

Some DMFs have been able to reinsure terrorism risks for members commercially. Assuming the DMF exercises its discretion in its members' favour, these DMF members would be able to transfer some terrorism risks to the insurance market. However, commercial cover for terrorism risks costs more than reinsuring such risks with the ARPC. There are also greater limits and restrictions on this cover.

As such, allowing DMFs access to the scheme would ensure that DMF members would no longer have to bear all their own terrorism risks or seek commercial terrorism cover.

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96 The Australian Government has accepted the recommendations of the *Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers* and, through a December 2005 discussion paper, is considering the implementation of those recommendations, including the prudential regulation of DMFs.

DMFs structure their business to ensure that they are not subject to legislation applying to insurance companies and insurance products. If DMFs were allowed access to the scheme, but still did not have to abide by other regulation applying to insurance companies (such as the *Insurance Contracts Act 1984*), then this may give DMFs a competitive advantage over insurers.

The scheme was specifically designed to apply to insurance contracts. Changes to the scheme to take into account non-insurance products would add considerable complexity and cost.

DMFs retain discretion over whether or not to pay a claim. However, the Act operates so that terrorism exclusions in insurance policies have no effect. The Act could therefore not be easily extended to cover DMF products. This is because, even if a terrorism exclusion in a DMF product was deemed to have no effect, DMFs would still retain the discretion to refuse to pay a claim. This discretion would undermine the certainty the Act was designed to provide.

Hence, the Government would have to amend the Act to address this issue, involving costs to the Government. It may also involve costs to DMFs, as legislative changes would be likely to limit the discretionary nature of DMF products, at least in relation to terrorism risks. The effect of this would be that a DMF would no longer be able to use its discretion to refuse to pay a claim relating to terrorism.

Conclusion

Allowing DMF products access to the scheme would involve a transfer of risk from DMF members to the Government and thus to Australian taxpayers. DMFs structure their business to avoid insurance regulation and it is this choice of structure that means the scheme does not apply to DMF products. To change the scheme to accommodate DMFs would be complex and costly. It would not necessarily increase certainty for DMF members. For these reasons, the costs associated with including DMF products in the scheme outweigh the benefits.

ENCOURAGING COMMERCIAL INVOLVEMENT

INTRODUCTION

An important principle of the terrorism insurance scheme is that it should allow the re-emergence of the commercial market for terrorism risk cover.

As part of the examination of the scheme, this review focused on those elements that encouraged or required commercial market involvement, particularly the collection of premiums and insurer retention levels.

Stakeholders provided comments on these matters. Of particular interest to stakeholders was whether the scheme would continue to collect premiums once the pool reached $300 million. Stakeholders also suggested ways to encourage greater commercial market involvement, including changing retention levels under the scheme and changing the way that premiums are calculated in relation to bundled insurance products.

This chapter considers whether, three years since the scheme's commencement, refinements should be made to the scheme to encourage greater involvement of the commercial insurance market in providing terrorism risk cover.

After restating the principles upon which the scheme is based and outlining existing premium and retention levels, this chapter analyses the merits of refining the premiums charged and retentions imposed under the scheme.

Principles and existing premium and retention levels

Since the terrorist attacks in the United States of 11 September 2001, insurers and reinsurers have withdrawn insurance cover for terrorism risks around the world.

The Australian Government intervened to prevent any wider economic impacts arising from the withdrawal of cover for terrorism risks for commercial property in Australia.

Prior to establishing its terrorism insurance scheme, the Government decided that any intervention should be consistent with:

- the need to maintain, to the greatest extent possible, private sector provision of insurance;
- the need to ensure that risk transferred to the Commonwealth is appropriately priced to minimise the impact on the Commonwealth's financial position, and to ensure that the Commonwealth is being compensated by those benefiting from the assistance;
- the need to allow the commercial insurance and reinsurance markets to step back in when they are able (that is, ensuring an appropriate exit strategy for Government); and
- the need to be compatible with global solutions.[97]

Australia's terrorism insurance scheme was created and intended to operate only while terrorism insurance cover continued to be unavailable commercially on reasonable terms. The scheme is designed to allow, and to some extent encourage, the re-emergence of a commercial insurance market for terrorism risks.

For example, the scheme does not provide reinsurance cover for all insurance policies. Many insurance policies, including in relation to residential property, remain outside the scheme and such policies provide an opportunity for commercial market intervention.

Insurers are currently required to pay for the reinsurance they obtain from the scheme, just like they would under commercial reinsurance arrangements. The premiums payable to the Australian Reinsurance Pool Corporation (ARPC) for reinsurance under the scheme are set by Ministerial direction. Current rates are set at 2, 4 or 12 per cent of the underlying premium.[98]

Insurers are also required to retain a certain amount of terrorism risk. Currently, there is no minimum insurer retention level but maximum insurer retentions are set at the lesser of:

- $1 million; or
- 4 per cent of the insurer's gross fire and industrial special risks (ISR) premium collected (less any fire services levy).

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97 Above n 17.

98 *Treasurer to Australian Reinsurance Pool Corporation (Premiums) Direction 2003*.

Insurers are required to retain this risk for 12 months at a time. There is also a maximum industry retention level of $10 million per event.[99]

Collection of premiums

The *Terrorism Insurance Act 2003* (the Act) gives the ARPC the power to collect premiums for the reinsurance cover it provides.[100] Premium rates have been set by Ministerial Direction.[101]

Issue

Once the ARPC has accounted for administration costs, there are no specific requirements on how the ARPC is to use premiums collected. However, the Australian Government indicated that the ARPC should initially use premiums to fund a $300 million pool. This is what the ARPC is currently doing.

Neither the Act nor the Ministerial direction specifies that premium collections will change once the pool reaches $300 million. As such, unless these Ministerial directions are amended, the ARPC will continue to be required to collect premiums after the pool reaches $300 million.

Some stakeholders have suggested that the ARPC should cease collecting premiums once the pool reaches $300 million.

Analysis

Two key principles of the scheme are that it should encourage greater involvement of the commercial market in providing terrorism risk cover and that the Government should be compensated by those benefiting from the scheme. The only way to adhere to these two principles is for the scheme to continue collecting premiums.

If the ARPC ceased collecting premiums from insurers in return for providing reinsurance cover, it would be charging nothing for the risk that was transferred to it. It would be impossible for commercial reinsurers to ever compete with the ARPC.

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99 *Treasurer to Australian Reinsurance Pool Corporation (Risk Retention) Direction 2003.*
100 Paragraph 11(2)(a).
101 Above n 98.

As a consequence, commercial insurers currently offering terrorism cover in competition with the ARPC would withdraw this cover. It would also prove to be a disincentive for the commercial insurance market offering new terrorism cover.

As well as conflicting with principles of the scheme, ceasing to collect premiums involves other substantial costs.

Although it may be assumed that the value of the $300 million pool would increase due to the additional investment returns, it is likely that over time the value of the overall scheme would not keep pace with the value of risks covered, especially taking into account increasing property values, the emergence of new risks, and possible increases in the number of policies reinsured with the ARPC. In particular, the value of the $10 billion indemnity provided by the Commonwealth (made up of a $1 billion line of credit guaranteed by the Commonwealth and a $9 billion indemnity) would decrease over time.

This decrease in the value of the scheme and the Government indemnity would impose increased costs on commercial insurance policyholders. The greater the extent that the value of the cover provided by the scheme fails to keep pace with the value of the risks covered, the greater the chance that the scheme would be insufficient to cover all insured losses if a large terrorist incident was to occur. (Recall that the Act requires the Treasurer to specify a reduction percentage if the total amounts payable by the Government would be greater then $10 billion.)[102] Ceasing to collect premiums therefore means there is a higher probability that policyholders would not fully recover their losses from a declared terrorist incident.

Given the indemnity currently provided by the Commonwealth is already substantial, it is difficult to conceive of a sufficient case to increase it in the short or medium term to maintain the value of the scheme, rather than collect premiums.

If premium collections stopped when the pool reached $300 million, new insurers and new policyholders would pay nothing upfront for terrorism risk cover. New insurers and policyholders would essentially get a 'free ride'.

For example, if, after the pool reached $300 million, a terrorist incident caused $200 million damage to a building that belonged to a policyholder who had never contributed premium to the scheme, the pool would still cover that damage. Post event, all insurers (and then policyholders) would be charged

102 Section 6.

premiums again to ensure the pool returned to $300 million. This would affect all policyholders, both new and old.

In this scenario, policyholders that originally contributed premium to the scheme would pay approximately twice as much for covering losses arising from a terrorist incident while the new policyholder would only pay premiums after an incident occurred. Nevertheless, it would be this new policyholder who received the benefit of cover.

An alternate option to ceasing to collect premiums is to reduce premium rates. In the commercial market, premium rates would only be reduced if the risk had reduced or if the cost of replacing or repairing the insured property had reduced. However, neither of these is true.

The threat of terrorism continues to be at the 'medium' level in Australia.

According to the Australian Bureau of Statistics, the cost of construction for non-residential buildings increased from 2003 to 2005.[103] The ABS Price Index of the Output of the General Construction Industry provides that from 2002-03 to 2003-04, construction costs increased by 9.03 per cent and from 2003-04 to 2004-05, construction costs increased by a further 9.87 per cent.

In addition, some insurers are starting to again cover certain terrorism risks (for example, selected facultative terrorism cover on specific low-risk sites). This suggests that some commercial insurers believe they can compete with the premiums charged by the ARPC for some risks in selected locations.

If the ARPC continues to collect premiums at the current rates once the pool reached $300 million it could use additional premium income to increase the size of the pool or purchase reinsurance for the scheme. Both of these options would reduce the risk that the Government, and hence Australian taxpayers, would be required to cover losses sustained if a terrorist incident was to occur.

103 *ABS 2006 Yearbook*, figure 19.14, 515.

The ARPC has advised that over the next three years, assuming it continues to charge premiums, it expects to receive premium income of approximately $100 million per year.[104] This is the price charged by the ARPC to policyholders for covering potential losses across Australia in 2005-06 of up to $1,925,056 million.[105] If the ARPC was to continue adding all premiums to the pool, by the time the scheme is next required to be reviewed in 2009, the pool would reach approximately $550 to $585 million.[106]

If the ARPC sought reinsurance for the scheme, this may encourage more commercial reinsurers to consider providing terrorism risk cover in Australia.

Conclusion

A key principle underpinning the terrorism insurance scheme is that it should encourage greater involvement of the commercial insurance market in providing terrorism risk cover. Another principle is that the Australian Government should be compensated for any risks it assumes. If the ARPC offered reinsurance for no charge, the Government would not be compensated for providing terrorism risk cover and commercial reinsurers would be unable to compete with the scheme.

As such, the scheme should continue to charge reinsurance premiums to encourage commercial market involvement. Also, if the ARPC indicates it is interested in buying reinsurance for the scheme, this may generate further interest from the commercial reinsurance market.

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104 ARPC estimate, assuming all things remain equal.

105 Total exposure of the ARPC for 2005-06.

106 ARPC estimate. Assumptions made in reaching the estimate are that:

- gross written premium collection rates remain constant over 2007-08 and 2008-09;
- acquisition and deferred acquisition costs remain constant;
- ARPC expenses to increase by 5 per cent each year for 2007-08 and 2008-09;
- investment income calculated on the average cash and investment balances noted in the balance sheet for 2007-08 and 2008-09; and
- interest rate is the current cash rate of 5.75 per cent.

Recommendation

That the ARPC continues collecting premiums at the current rates, subject to further review in no more than three years. Once the pool reaches $300 million, the ARPC should be able to use its discretion to determine whether to use premiums to build the pool further, purchase reinsurance for the scheme or undertake a combination of the two.

RETENTIONS

As outlined above, insurers are required to retain some terrorism risk under the scheme. The review considered whether current retention levels are sufficient to encourage greater involvement of the commercial insurance market in providing terrorism risk cover.

Issue

It has been suggested that, by industry and international standards, the maximum insurer retention for the scheme is low.

Further, setting retentions at a maximum of 4 per cent of an insurer's Australian gross fire and ISR premium also results in some insurers having very small retentions. For example, there are 124 insurers reinsured with the ARPC with maximum retentions between $1,000 and $100,000.

The issue is whether a minimum retention should be introduced and whether the maximum insurer and industry retentions should be reconsidered to bring greater parity between the scheme, existing commercial practice and retentions in comparable schemes in other countries, thus encouraging greater participation of the commercial market.

Analysis

The maximum annual insurer retention under the scheme is the lesser of $1 million or 4 per cent of fire and ISR premiums collected by the insurer. There is no minimum annual insurer retention. The maximum per event industry retention is $10 million.

These existing retention levels are low compared to industry standards. Many large Australian insurers retain in excess of $10 million on property catastrophe treaties for one event. Other things being equal, having scheme retention levels significantly lower than commercial reinsurance retention levels makes it difficult for commercial reinsurers to compete with the ARPC. This may discourage greater commercial market involvement.

Raising the maximum retention levels would make reinsurance offered by the scheme more comparable to reinsurance arrangements offered commercially. Higher retention levels would require commercial insurers to assume more terrorism risk. Alternatively, insurers could seek a small amount of commercial reinsurance to cover their retention levels. Raising retentions also means that some risk is transferred from the ARPC and the Commonwealth (and ultimately Australian taxpayers) back to the commercial insurance market.

Introducing a minimum retention level would also require insurers to assume more risk. Some of these insurers may determine they can cover terrorism risks relating to their commercial insurance policies and cease reinsuring with the scheme. Minimum insurer retentions thus provide another way to encourage more commercial market involvement in providing terrorism risk cover.

Comparable schemes overseas have also raised retention levels to encourage greater involvement of the commercial market. Between 2003 and 2005, the United States of America raised insurer and industry retention levels under the Terrorism Risk Insurance Act. In 2003, insurer retentions were set at 7 per cent of an insurer's direct earned premium over the previous year. The government increased these in 2004 to 10 per cent and to 15 per cent in 2005. In 2003, industry wide maximum retention amounts were set at $10 billion. They were raised to $12.5 billion in 2004 and $15 billion in 2005.[107]

The United Kingdom also raised industry retentions under Pool Re. In 2003, industry wide retentions were set at £30 million per event and £60 million per year. These retentions were increased to £50 million and £100 million in 2004, £75 million and £150 million in 2005 and £100 million and £200 million in 2006.[108]

Along similar lines, from 2002 to 2004, France raised the amount that must be covered by commercial insurers and reinsurers before the state guarantee applies under GAREAT.[109]

It is proposed that scheme retentions be increased in three increments (with effect, respectively, from 1 July 2007, 1 July 2008 and 1 July 2009) as outlined in the table below.

107 OECD, above n 5, 95-6, 263.
108 Ibid, 96, 259.
109 Ibid, 95-6, 243-7.

Date	Annual insurer retention		Maximum industry retention per incident
	Minimum	Maximum	
Current	Nil	The lesser of $1 million or 4 per cent of fire and ISR premiums collected	$10 million
1 July 2007	$100,000	The lesser of $1 million or 4 per cent of fire and ISR premiums collected	$25 million
1 July 2008	$100,000	The lesser of $5 million or 4 per cent of fire and ISR premiums collected	$50 million
1 July 2009	$100,000	The lesser of $10 million or 4 per cent of fire and ISR premiums collected	$100 million

This proposal would affect 158 of the current 220 insurers that reinsure with the ARPC.

There are 124 insurers for whom 4 per cent of fire and ISR premium collected in Australia is equal to or less than $100,000. In total, these 124 insurers currently retain $5,507,372 of terrorism risks.[110] Introducing a minimum retention of $100,000 would require these insurers to retain, in total, an additional $6,892,628 of terrorism risk (assuming they all continue to reinsure with the ARPC).

There are 62 insurers for whom 4 per cent of fire and ISR premiums collected is greater than $100,000 but less than $1 million and hence would be unaffected by the recommended changes to retention levels.

There are 34 insurers for whom 4 per cent of fire and ISR premiums collected is equal to or greater then $1 million. These insurers currently retain $34 million of terrorism risks in total. How much additional risk these 34 insurers would hold under this proposal would depend on whether 4 per cent of fire and ISR premiums collected is less than or greater than $5 million and then $10 million, respectively.

Under this proposal, the insurance industry would be required to retain more risk for any one incident, first up to $25 million, then $50 million and then up to $100 million. In total, this will be an increase of $90 million in retentions for the insurance industry. However, even if the industry retention is $100 million

110 The ARPC has advised that 124 insurers in the scheme currently retain less then $100,000 of terrorism risks. In total, these 124 insurers currently retain $5,507,371.72 of terrorism risks. Increasing the minimum retention to $100,000 would require these 124 insurers to retain, in total, $12,400,000 of terrorism risks. This is an increase of $6,892,628.28.

per incident, this represents less than 1 per cent of the total cover provided by the scheme.

Whether or not an increase in retentions would have an effect on the capital requirements for individual insurers depends on the size of the insurer and the size of the retentions the insurer holds for other risks. However, the Australian Prudential Regulation Authority has advised that, broadly, it would expect that the majority of the industry would experience no increase in capital requirements for changes of the type proposed.

Many insurers choose to have retentions for commercial reinsurance that would be equal to or larger than the proposed maximum annual insurer retention levels. As such, the majority of insurers already hold sufficient capital to cover the retention increases proposed.

Conclusion

Increasing scheme retention levels will make them more comparable to commercial reinsurance and will require commercial insurers to assume more terrorism risk. Increasing retentions is more likely to encourage greater commercial involvement under the scheme than keeping retentions at the current levels. Raising retentions is also consistent with the actions of comparable schemes overseas.

Recommendation

That insurer retentions under the scheme be increased in three increments (with effect, respectively, from 1 July 2007, 1 July 2008 and 1 July 2009), as follows.

Date	Annual insurer retention		Maximum industry retention per incident
	Minimum	Maximum	
Current	Nil	The lesser of $1 million or 4 per cent of fire and ISR premiums collected	$10 million
1 July 2007	$100,000	The lesser of $1 million or 4 per cent of fire and ISR premiums collected	$25 million
1 July 2008	$100,000	The lesser of $5 million or 4 per cent of fire and ISR premiums collected	$50 million
1 July 2009	$100,000	The lesser of $10 million or 4 per cent of fire and ISR premiums collected	$100 million

PREMIUMS ON BUNDLED INSURANCE PRODUCTS

The ARPC notes that some businesses are concerned about the way it is required to calculate reinsurance premiums for bundled insurance products.

Issue

As a way of providing a more attractive service to commercial policyholders, insurers may sometimes choose to offer multiple types of cover relating to a range of different commercial risks (for example, fire or accidental damage) together as one insurance policy. The different types of cover become different sections of a single bundled insurance policy, which is considered to be a single 'eligible insurance contract' under the Act.

If the different sections of an 'eligible insurance contract' contain terrorism exclusions, then the Act applies so that those exclusions have no effect. In turn, insurers can reinsure such terrorism risks with the ARPC, in return for paying a premium.

In accordance with a Ministerial direction, the ARPC is currently required to calculate reinsurance premiums based on the underlying premium of each 'eligible insurance contract'.[111]

As a result, if a bundled policy is made up of some sections that exclude terrorism risks and some that do not exclude terrorism risks, the ARPC currently has no power to reduce the reinsurance premium it charges to take account of the lower risk it assumes because some terrorism risks are being borne by the insurer.

In other words, assuming the premium charged to each policyholder is the same, an insurer offering a policy that excludes all terrorism risks pays the same reinsurance premium to the ARPC as an insurer offering a bundled policy that excludes some, but not all, terrorism risks.

The issue is whether this may discourage insurers from covering certain terrorism risks under sections of a bundled insurance policy.

Analysis

The way the ARPC is required to collect premiums assumes that the ARPC reinsures all terrorism risks under a bundled insurance policy. However, this is

111 Above n 98.

not always true. Some insurers choose to cover certain terrorism risks under a bundled insurance policy. However, the ARPC cannot reduce the premium it charges to reflect the additional risk being borne by the insurer.

This could mean that a commercial insurance policyholder will effectively be charged twice in relation to cover for certain terrorism risks. That is, the policyholder pays an amount equivalent to the ARPC reinsurance premium (assuming it is passed on by the insurer) but also pays for cover provided by the insurer.

Or, the insurer absorbs the costs associated with providing cover for certain terrorism risks. That is, the policyholder pays an amount equivalent to the ARPC reinsurance premium (assuming it is passed on by the insurer) and the insurer assumes certain risks at no charge.

If insurers exclude all terrorism risks from bundled insurance policies, they assume less risk and charge policyholders less premium. As such, the current pricing structure for bundled insurance products discourages the commercial insurance market from providing limited terrorism risk cover in bundled insurance policies. This contrasts with a principle of the scheme, being to encourage greater involvement of the commercial insurance market.

To encourage insurers to provide some cover for terrorism risks in bundled insurance policies the ARPC should have the ability to charge premium on only those sections of the policy that exclude terrorism risks. In turn, to take advantage of this type of arrangement, insurers must be able to demonstrate that they are able to justify the pricing for the different sections of a bundled policy.

Conclusion

Allowing the ARPC to reduce the premium it charges on bundled insurance policies that insure some terrorism risks will remove a disincentive for insurers willing to cover terrorism risks.

Recommendation

That the ARPC be required to charge reinsurance premiums on only those sections of a bundled policy that exclude terrorism risks.

APPENDIX

CONSULTATION WITH STAKEHOLDERS

As part of the review, the Treasury consulted the following stakeholders:

- American Insurance Group;
- Aon Re Australia Ltd;
- Australian Prudential Regulation Authority;
- Australian Reinsurance Pool Corporation;
- Attorney-General's Department;
- Australian Bankers' Association;
- Benfield (Australia) Limited;
- Charles Taylor Consulting (Australia) Pty Ltd;
- Insurance Council of Australia;
- Lloyd's Australia Limited;
- National Insurance Brokers Association of Australia;
- Property Council of Australia; and
- Swiss Re (Australia) Limited.