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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TERRORISM INSURANCE BILL 2002

EXPLANATORY MEMORANDUM

(Circulated by authority of the Treasurer,
the Hon Peter Costello MP)

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TERRORISM INSURANCE BILL 2002

Outline

- 1.1 Following the events in the United States of September 2001, cover for terrorism risk was progressively withdrawn by insurance and reinsurance companies. Significant commercial and financial difficulties have resulted from the withdrawal of such coverage. With a large pool of assets uninsured for terrorism risk, financiers and investors face uncertainty that could result in adverse economic circumstances, delaying commencement of investment projects and altering portfolio management decisions.
- 1.2 The Terrorism Insurance Bill 2002 establishes the framework to implement the scheme for replacement terrorism insurance announced by the Treasurer on 25 October 2002. The development of the Scheme followed calls from the community for the Government to intervene in an area of clear market failure and subsequent discussions with key industry stakeholders.
- 1.3 The Bill deems all eligible insurance contracts to include terrorism risk cover. Eligible insurance contracts have a starting point definition of insurance for physical loss or damage to tangible property located in Australia, and associated business interruption and public liability cover. The eligible insurance contracts will be further refined through regulations.
- 1.4 The compulsory deeming of terrorism cover is essential to allow accumulation of a credible funds pool within a reasonable period. Universal terrorism insurance is designed to avoid problems of undiversified risks (for example, insuring only high risk buildings) and

uncertainty as to who will be eligible for compensation in the event of a terrorist act.

- 1.5 The Bill also establishes a statutory authority – the Australian Reinsurance Pool Corporation – which will provide reinsurance cover to insurers for losses arising from a declared terrorist incident. The Minister will appoint a chair and up to six other part-time members to the Corporation. The Corporation will also appoint a full-time Chief Executive Officer.
 - 1.6 Insurers who seek terrorism reinsurance through the Australian Reinsurance Pool Corporation will retain part of the risk of liability from a declared terrorist incident. The Treasurer will set the retention by issuing directions to the Corporation. Initially it is anticipated that the retention will be set at \$1 million per insurer per annum, and \$10 million across the industry per event.
 - 1.7 The Treasurer will also be able to direct the Australian Reinsurance Pool Corporation on premiums to be charged (based on underlying base premium) for the reinsurance. Premiums collected from insureds will be paid by insurers to the Scheme in order to fund a \$300 million pool and to repay any loan required in the event claims exceed the resources of the pool.
 - 1.8 The Government’s objective is to operate the Scheme only while terrorism insurance cover is unavailable commercially on reasonable terms. As such, reviews of the Scheme and the global terrorism risk reinsurance market will be conducted every two or three years, to assess the state of the market and the possible wind-up strategy of the Scheme. The uncertainty in the market makes it impossible to stipulate on establishment the details or timing of the windup of the Scheme and the use of funds accumulated by the Scheme. Components of the Scheme, including pricing, classes of insurance required to provide terrorism risk cover and level of underwriting available, are deliberately flexible, not being set in legislation, in order to encourage the reemergence of the commercial market.
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Financial Impact Statement

- 2.1 The Bill provides that the Commonwealth guarantees the due payment of money that may become payable by the Corporation to any person other than the Commonwealth.
- 2.2 The ABS advised that the Australian Reinsurance Pool Corporation would be classified as a Public Financial Corporation. As a result, premium income and any payment of claims will not impact on the underlying cash balance of the general government sector. The budget impact of the scheme would result from the receipt of fees for the indemnity expected to be provided by the Commonwealth, establishment costs of \$2 million and any costs borne by the general government should the entity default on its loans or other liabilities. The guarantee will be recorded as a contingent liability in the Commonwealth's accounts.
- 2.3 The Australian Reinsurance Pool Corporation is not subject to income tax under a law of the Commonwealth.

Regulation Impact Statement

Since the terrorist attacks in the United States of 11 September 2001, insurance and reinsurance companies have withdrawn cover for terrorism risk for property owners in Australia (as has occurred worldwide).

Terrorist risk is very difficult to price for insurance purposes. Generally, actuarial models set premiums based on two key factors: the probability of occurrences and the size of losses. Terrorism represents potentially enormous losses with unpredictable frequency. Inability to address this problem of incomplete information means that insurers and reinsurers face difficulty determining appropriate premiums and writing insurance contracts for this type of risk. However, insurance companies are currently investigating methodologies that could allow them to overcome this problem.

The initial impact of this market failure was on the aviation sector. Reinsurers and insurers generally gave notice that coverage for terrorist risk would be terminated almost immediately. The Commonwealth Government and many other governments around the world instituted arrangements to avoid a shutdown of the industry. In Australia, this has been in the form of an indemnity to cover third party terrorist risk.

The withdrawal of insurance cover for terrorist risk has affected most insurance policies in Australia, not just the aviation sector, as existing insurance policies came up for renewal.

The Treasury commissioned an assessment of the Australian market by Trowbridge Consulting, assisted by Chilton International, in June and July 2002 which found that virtually no terrorism-related insurance cover is available for commercial property and business interruption. Where cover is available, it is at prices that far exceed the perceived cost of the risk, with large excesses and relatively low maximum coverage, compared to the market cover previously available. Trowbridge's survey indicated that the available capacity for terrorism risk insurance is not being filled, presumably due to the cost associated with purchasing such insurance. Most insurers do not offer terrorist risk within property cover as the insurers cannot obtain reinsurance. Were insurers to offer such cover, internal governance issues and possibly regulatory issues would arise. More recent indications are that the market has not materially improved since then. Whilst cover is emerging for domestic property, there is no indication that the wider market will recover in the short to medium term.

The absence of insurance cover for terrorist risk is not a problem for any property holder who considers their property at low risk, or is prepared to accept the risk themselves.

The absence of cover is a problem for property owners who do consider themselves at some risk and who are not in a position to assume that risk. Commercial property owners, banks, superannuation funds and funds managers have been forced to assume insurance risk as policies reached their expiry date. These institutions are not set up to manage insurance risk, and in the case of some bodies, notably superannuation funds, are specifically precluded from taking risk on board.

Some property owners are under contractual obligations to maintain full insurance cover, including for terrorist risk. For example, lenders would usually require larger commercial borrowers for property to maintain comprehensive insurance. Further, property and superannuation trusts that hold property may have contractual fiduciary responsibilities to fully insure.

In the medium term, it is possible that the pattern of economic activity would be affected by the transfer of risk from insurance companies to property owners, including a reduction in lending for commercial buildings and infrastructure.

With a large pool of assets uninsured for terrorism risk, financiers and investors face uncertainty that could result in adverse economic circumstances, delaying commencement of investment projects and altering portfolio management decisions. In the US, for example, a recent Real Estate Roundtable survey found that more than \$US15.5 billion worth of real estate projects in 17 states had been stalled or cancelled because of a scarcity of terrorism insurance.

Also of concern is the lack of cover for public liability insurance associated with commercial property and infrastructure. Thirty-four per cent of insurance claims following the terrorist attacks in the US in September 2001 resulted from public liability. However, the possible public liability risks from terrorist event are even harder to quantify than risks to commercial property.

In addition, there is also an effect on State and Territory statutory schemes. Certain States' and Territories' compulsory workers' compensation and compulsory third party (CTP) motor vehicle schemes are commercially underwritten and insurance companies have been facing difficulties in meeting the required level of coverage, which includes terrorism risk. State and Territory initiatives to address the industry's problems so far have been inconsistent, incomplete and uncertain in duration.

There is increasing consensus among most OECD countries that some form of government intervention is required to correct the problem of the lack of insurance cover. The United States, France and Germany have recently

established arrangements. The United Kingdom and Spain have longstanding arrangements that have been adapted to current circumstances.

Policy objective

In general, the Government is seeking to establish an interim measure to address a market failure arising from the inadequate supply of terrorism risk cover.

The Government determined in May 2002 that it should act to ensure some form of insurance cover is available, with a mixture of a pool and post-funded model. 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 would need to be consistent with:

- the need to maintain, to the greatest extent possible, private sector involvement;
- ensuring that risk transferred to the Commonwealth is appropriately priced and that the Commonwealth is compensated by those benefiting from the assistance;
- allowing the re-emergence of the commercial markets for terrorism risk cover; and
- global solutions.

After industry consultations conducted with the assistance of Trowbridge Consulting, the Government decided to adopt a hybrid pool/post-funded model broadly consistent with these parameters and principles. The Scheme involves the accumulation of a cash pool of \$300 million funded by premiums, backed by a commercial line of credit of \$1 billion and a Government indemnity of \$9 billion respectively. This is expected to provide a sufficient level of certainty and public confidence in coverage available against terrorist risk, with premiums more affordable than currently exist at market prices.

A critical factor is that the Government does not wish to be involved in the insurance market in the long term. Any involvement is to be directed at alleviating problems faced by commercial property owners who are unable to obtain terrorist risk insurance. For this reason, other classes of insurance have not been included (such as domestic property, marine and aviation insurance). Similarly, coverage will not extend to damage resulting from nuclear causes. Such damage has been excluded from insurance for a significant period and is unlikely to ever be covered by the commercial market. The Scheme will be regularly reviewed with a view to, among other things, testing the extent to which the commercial market is re-emerging for terrorist risk insurance.

Therefore, the extent to which the Government covers such risks may limit its ability to withdraw.

Some regulatory authority will be required to ensure that Government's preferred structure is implemented in a practical and effective manner. There is currently no regulation/policy in place with regard to the level of terrorism risk cover provided, although, as noted above, some State and Territory statutory schemes stipulate that comprehensive insurance must cover this form of risk.

Implementation options

Once the Government determined that it should act to intervene in the market with a hybrid pool/post-funded model, the options available for implementing the Scheme were narrowed. The legislation establishes a statutory authority (the Australian Reinsurance Pool Corporation, or ARPC) to manage the terrorism risk insurance scheme. The regulatory issues to be addressed relate to the level of participation required from insureds and insurers.

- The Government could allow insureds to choose whether or not to take out terrorism insurance, and allow insurers the choice of whether or not to offer this insurance. In this case, no regulation regarding participation in the Scheme would be required.
- The second option relates to requiring universal participation from all commercial property owners. The Government would legislate that commercial property owners be required to pay a levy to the Scheme, which would insure their property on the same terms as their standard commercial property insurance. Associated public liability and business interruption would be covered similarly. Inclusion of State statutory schemes would be subject to discussions with the States and Territories.
- Thirdly, the Scheme could legislatively compel insurance companies to provide cover for terrorism risk in policies written for those classes of insurance covered by the Scheme (principally that is, commercial property, business interruption and associated public liability). As such, if insureds choose to take out commercial property insurance, they must also be covered for terrorism risk.
 - Insurance companies would be able, *but not obliged*, to reinsure their terrorism risk exposure with the ARPC. If they chose to reinsure that risk with the ARPC, any liability held by these insurers would be met fully by the Scheme, apart from any initial retention. The retention would be set in the reinsurance contract between the ARPC and the insurer, and is envisioned to be \$1 million per annum.

Assessment of impacts

Option 1. Optional participation

Under this option, no insurer or insured would be compelled to offer or take out terrorism risk cover. Property owners who considered themselves to be at low risk from terrorism would not be compelled to participate. Similarly, insurers not wishing to offer insurance could opt out, but those who choose to offer such cover could seek reinsurance with the Scheme, at a rate significantly lower than that currently available commercially.

Analysis by Trowbridge suggests that this option would be unworkable, as it would likely give rise to adverse selection problems and would result in the very slow establishment of the pool. Given the small size of the domestic market, the success of a pool fund in Australia depends on compulsory participation. A voluntary scheme will probably have a low take-up rate, restricted to those who perceive themselves as high risks. With compulsion, a pool of about \$300 million should be built up over about three years. On a voluntary basis, the pool would have difficulty in achieving that amount within a suitable timeframe without requiring higher premium levels.

Voluntary participation would also mean that there would be a smaller base to shoulder the burden of repayments after any claims are made under the arrangements. A key principle in developing the Scheme has been that the Commonwealth should be compensated by those benefiting from its coverage. The Commonwealth would have difficulty in recovering a large payout from the beneficiaries of a voluntary, narrow arrangement and would in essence be carrying a large risk with little chance of repayment in full in the case of a major terrorist event.

From the viewpoint of commercial property owners, the possibility of a large contingent liability in the event of a terrorist act, to be met by a narrow base of insureds, may discourage the participation of insureds.

Furthermore, the level of administration required (and therefore the costs of running the Scheme, whether met by Government or premium-payers) would be very large compared to options 2 and 3, given that not all insureds would be covered for terrorism and the ARPC would need to keep records for each individual policyholder that opts in to the Scheme. In the event of a terrorist incident, the ARPC would be required to differentiate between those property owners who have taken out insurance and those who have not. The Government would also likely be under pressure to provide some form of compensation for those who chose not to take out terrorism insurance.

Option 2. Universal participation through a levy

The universal participation proposed under the second option addresses concerns with regard to adverse selection and a small base. Compulsory acquisition of terrorism cover is essential in Australia if the Scheme is to be able to accumulate a credible funds pool within a reasonable period.

Universal participation would also provide certainty with regard to eligibility for post-event compensation. This option avoids free-rider behaviour. Given that in the event of a terrorist attack, those businesses that chose not to take out terrorism risk cover are likely to still argue strongly for government financial support, the requirement of terrorism risk insurance should reduce the prospect of the Government having to meet additional high costs from uninsureds should an event occur.

Key impact groups for this option would be all commercial property and infrastructure owners (including both small and large businesses in all regions of Australia), and the ARPC.

With regard to costs to insureds, all classes of commercial property owners would be required to purchase insurance, whether or not they considered their property to be at risk from terrorism. This may attract criticism, especially in rural areas where the risks of terrorist attack will be perceived as being minimal. However, it is important to note that damage from terrorist attacks can in fact be incurred quite remote from the centre of such attacks, for example, where energy or water infrastructure are targeted, interrupting the operation of business.

The actual cost to insureds would depend on the premiums charged; however the intention would be to vary cost depending on risk – specifically, by location. Greater analysis of costs to insureds is addressed in the section on premium costs below, which is also relevant to option 3.

In requiring universal participation for all owners of commercial property in Australia are covered for terrorism risk, the administration costs for the ARPC are reduced as detailed individual records would not be required.

Costs for insurers would be minor as they would have little role to play. However, this is a reflection of one of the main weaknesses of this option – that it does not involve commercial insurance participation and so fails to meet one of the four key principles outlined above. As the Scheme is intended to be a interim solution to a current market failure, participation of insurance companies should be encouraged as much as possible.

Also, a compulsory arrangement of this type would probably constitute a tax. In addition to questions of the desirability of a ‘terrorism insurance tax’, this

would also create difficulties in setting levies for the arrangements that reflect risk, due to the Constitutional prohibition on discriminating between States and parts of States in setting taxes.

Option 3 – Universal participation through compulsory provision of insurance and optional reinsurance with the Australian Reinsurance Pool Corporation

The costs and benefits of this option are similar to those above. However, the key impact groups now include insurers, as well as commercial property owners and the APRC, as their role in the Scheme will be significantly increased from that proposed by option 2.

In addition to the advantages of universal participation outlined for the ‘levy’ option above, this option has the further advantage that it does not force nor encourage commercial insurers and reinsurers to withdraw from the domestic market.

One of the key benefits of the engagement of commercial insurers will be in assisting with the intended windup of the Scheme once biennial reviews establish that the commercial market has re-emerged sufficiently and can provide affordable and adequate terrorism risk cover. Without such participation, the market would be less likely to re-engage this type of risk, or would do so at a slower rate. Flexibility built into the Scheme will allow market participation in the Scheme to be increased at an appropriate rate.

Costs to insurers who choose to reinsure with the ARPC will be limited to a degree by the provision of full reinsurance by the Scheme, and the liability resulting from terrorism risk insurance should have little implications for their capital requirements. The need to seek reinsurance is a standard cost of business for insurance companies, however in this case the cost is imposed by the compulsory provision of terrorism insurance envisioned in option 3, rather than the choice of the insurer to take on that risk and corresponding cost.

However, there will be some costs to insurers associated with the proposed \$1 million per annum retention. Claims resulting from a terrorist incident or a number of terrorist incidents that total less than \$1 million in any one year must be met by the insurer, without the ARPC providing any reinsurance. This cost is to some extent the counterpoint to the efficiency benefits gained by limiting the role of the ARPC to large terrorist claims and the longer-term benefits to the insurance market of encouraging continuing industry participation in the provision of terrorism risk insurance. Further, the introduction of a retention by insurers reduces potential costs to the ARPC in the event of a claim.

The \$1 million per annum potential liability for each insurer that reinsures with the ARPC could itself be reinsured commercially if the insurer so wished, as the capped exposure would make reinsurance more likely to be available.

However, costs of such reinsurance would need to be met by the insurer and may result in an increase in the premium charged to affected insureds, at the insurer's choice.

In addition to the costs of seeking reinsurance for risk retained, the costs to insurers of necessary changes to systems and of on-going compliance costs with regard to collecting premiums and transferring them to the Scheme would not be insignificant.

The possible inclusion of state statutory schemes, and any resulting charges or sharing of costs, will need to be discussed with those jurisdictions.

Option three has an additional advantage over option two in terms of simplicity of implementation. As the insurance powers under the Constitution, rather than tax powers would be used for option 3, it would not face the constitutional impediment in varying charges by location.

Premium Costs to Insurers and Insureds from option 2 and 3

The actual costs to insureds and insurers will depend on the level of premiums set by the reinsurance company to charge insurers. Insurers would then be able to pass these costs on to insureds.

The legislation allows the Treasurer to direct the ARPC to set particular premiums. Terrorism risk premiums to be charged by insurers to policyholders will not be set by the Government. It is proposed, nevertheless, to explore possible acceptable cost recovery arrangements for insurers in regard to reinsurance premiums charged by the Scheme. More generally, commercial market pressures can be expected to ensure that premiums charged to policyholders do not significantly exceed charges for reinsurance.

Initial calculations suggest reinsurance premium levels between 2 and 12 per cent (depending on risk and location, and averaging 5 per cent) of underlying commercial property insurance premiums would be adequate to build the pool and would not be a significant cost to smaller commercial property owners if passed on generally unchanged by insurers. As potential public liability costs would be difficult to quantify, there would initially be no charge for coverage of terrorism risk in this class of insurance. However, premiums would be required for this class of insurance, and would be increased for the other eligible classes, in the event of a significant claim on the Scheme. See Table 1 below.

TABLE 1 – POSSIBLE PREMIUM STRUCTURE FOR REINSURANCE

Class of insurance	Initial rate (from 1 July 2003)	Maximum rate (after an event)
Commercial Property*	2%	6%
- surcharge for CBD property	10%	30%
- surcharge for urban property	2%	6%
Public Liability	-	2%

Notes

* Commercial property includes agriculture and forestry, but excludes marine property, transport and farms not covered for business interruption risk.

Some criticism from CBD property owners is possible, for whom the reinsurance premium would be around 12 per cent of underlying insurance premiums. However, this level is below the price of any commercially-provided insurance currently available (on limited terms). This rate also compares well in relation to charges for similar government-run schemes overseas. For example, the French scheme has three bands of charges – 6, 12 and 18 per cent of the direct premium – which increase depending on the sum insured.

At the smaller end of the market, analysis of current premiums indicates that the additional burden on small commercial operators will not be excessive. Indicative data provided by the Insurance Council of Australia, in particular, suggests that many property owners insure principally for fire risk. For this, and prior to any additional premium for terrorism cover, a regional corner store with around \$200,000 in stock would pay a base premium of about \$480. GST, stamp duty and State fire service charges might increase this to around \$750 (around 50 – 60 per cent). A suburban supermarket with \$500,000 of stock might pay \$1,200 plus taxes and charges, a small office block with \$1 million of fittings \$1,500 and a (high fire risk) woodworking establishment with \$250,000 in stock etc about \$1,600 plus taxes and charges. These numbers suggest that the premium scales proposed would not add appreciably to property insurance costs in rural and urban areas: i.e. around \$15 to \$35 a year.

There will be no costs to smaller farms that do not take out insurance for business interruption insurance against loss of profit, as owners of such property will not be compelled to purchase terrorist risk insurance. However, there is sufficient flexibility in the Scheme that the ARPC would be able to offer reinsurance to providers of terrorism risk cover for small farms, should compelling arguments for its provision emerge.

Premium levels would need to be reviewed regularly, assessing the state of the pool and the impact of such premiums on the industry. Ensuring competitive neutrality will be an important factor in the Treasurer's assessment of requested premium levels once the immediate market failure has begun to be addressed and competition returns to the global market.

Other issues – consultation

Development and assessment of options has been undertaken in consultation with the Departments of Prime Minister and Cabinet, Finance and Administration and the Attorney-General.

A number of consultations with the major interested parties have been conducted by and on behalf of Treasury since January 2002. The opinions and suggestions of leading industry groups, insurers, property owners and banks have been sought and incorporated when developing the Scheme.

At Treasury's request, Trowbridge Consulting undertook a survey of industry stakeholders (insurance and reinsurance companies, banks, representatives of property owners, industry associations, insurance brokers and actuaries) in June and July 2002 and discussed the survey at individual follow-up interviews. The key finding of these consultations was that there is virtually no traditional insurance cover available for commercial property and business interruption regarding terrorist acts within property insurance policies. At that time, only one authorised insurer offered any capacity specific to terrorism risk insurance, and that was capped both overall and in relation to each capital city centre. While available capacity has increased slightly since December 2001, it remains subject to highly restrictive conditions which limit its effectiveness. Most insurers indicated that they could not consider including terrorism cover as the lead reinsurers and retrocessionaires were not offering any capacity. A softening of the market for terrorism risk in respect to domestic property and small and medium enterprises was noted.

Additional consultations on the proposed model were conducted with a similar set of stakeholders in August 2002. Most stakeholders indicated their satisfaction at the Government's efforts to address the matter of availability of cost efficient terrorism insurance. The most common concerns among property owners related to the short timeframe required for developing the Scheme and

the proposed universal participation for commercial property owners. Attempts to address misgivings relating to required participation have been made, by allowing insurers to seek or retain commercial insurance and by significantly varying premiums according to risk. However, due to the structure of the hybrid pool and post-funded model, and the intended short lifespan of the Scheme, universal participation remains an essential component of the Scheme.

Insurers were concerned by the initial proposal of a \$20 million threshold per event, below which insurance companies would meet the cost of any claims resulting from a terrorist attack. Their main concerns related to the possibility of a single insurer facing \$20 million worth of claims. Attempts have been made to address this concern by introducing thresholds of \$1 million per insurance company per annum or \$10 million per event before the Scheme enters into compensation arrangements. However, the Insurance Council of Australia has continued to express its dissatisfaction with this level of retention.

Consultation has continued throughout drafting of the legislation and will further continue during implementation of the Scheme and the statutory authority. The Property Council of Australia and the Australian Bankers' Association have indicated their support for the arrangements.

In addition, consultation with the States and Territories will be necessary in respect of statutory schemes. The Treasurer has written to his State and Territory counterparts, outlining the Scheme and offering the option of participating.

Conclusion and recommended option

Option 3 provides the best balance of effective and equitable implementation of the Government's terrorism risk insurance scheme.

- The need for broad participation to ensure the scheme runs effectively rules out option 1, which is based on voluntary participation.
- Option 3 has the advantage over option two that it ensures insurance industry participation, which will not only assist in running the Scheme but also allow for the re-emergence of a fully competitive market, and thereby facilitating the ultimate windup of Government participation in the market.
- Option 3 also avoids the constitutional problems of varying premium charges by location that would be faced by option 2.

Implementation and review

Full implementation will require the cooperation of insurance companies so further consultation throughout the implementation and review of the Scheme will be essential.

A transition period, commencing from the Scheme's startup date of 30 June 2003, will be necessary, as terrorism risk coverage will be deemed into existing contracts without any charges for such coverage being levied until the date of renewal. During this period, reinsurance will be provided by the ARPC free of charge, in order to avoid forcing a liability onto insurers for which they cannot charge additional premiums to offset the new risk.

The Government's objective is to operate the Scheme only while terrorism insurance cover is unavailable commercially on reasonable terms. As such, reviews of the Scheme and the global terrorism reinsurance market will be conducted every two or three years, to assess the state of the market and the possible wind-up strategy of the Scheme. Such regular reviews are necessary given the uncertainty in the market makes it impossible to stipulate on establishment the details of timing of the windup of the Scheme and the use of funds accumulated by the Scheme. Components of the Scheme, including pricing, classes of insurance required to provide terrorism risk cover and level of underwriting available, are deliberately flexible, not being set in legislation, in order to encourage the reemergence of the commercial market.

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Notes on Individual Clauses

PART 1 - PRELIMINARY

Clause 1 — Short Title

This clause provides for the Act to be cited as the *Terrorism Insurance Act 2002*.

Clause 2 — Commencement

This clause is about the commencement of the Act, and provides for the Act to commence on Royal Assent.

Clause 3 — Definitions

Clause 3 defines the meaning within the Act of certain expressions.

Clause 4 — Act extends to things outside Australia

This clause provides that the Act extends to acts, omissions, matters and things outside Australia, unless the contrary intention appears. An example of a contrary intention is the requirement in clause 6 that the terrorist act must happen in Australia for it to be a declared terrorist incident.

Clause 5 — Meaning of *terrorist act*

Clause 5 defines the meaning within the Act of *terrorist act*. This definition draws upon the meaning of *terrorist act* set out in Chapter 5, Part 5.3 of the Criminal Code – Schedule to the *Criminal Code Act 1995*. The reason for this is to have consistency across Commonwealth legislation.

PART 2 – INSURANCE FOR TERRORISM RISKS

Clause 6 — Declared terrorist incidents

This clause sets out the circumstances in which the Minister must declare that an act constitutes a declared terrorist incident for the purposes of this Act. The Minister would be required to seek advice from the Attorney General before declaring that an act constitutes a declared terrorist incident (DTI).

For a terrorist act to be a declared terrorist incident, it must have happened in Australia. In relation to this condition, a threat of an action is only taken to have happened in Australia if the threatened action would happen in Australia. This means, for example, that if a person in Australia threatens something within the definition of *terrorist act*, but the threatened action would happen in a place outside Australia, then that threat would not be a declared terrorist incident. If a person outside Australia makes a threat within the definition of *terrorist act*, and the threatened action would happen in Australia, then that threat would be eligible to be a declared terrorist incident.

A threat of an action cannot be taken into account for declaration unless the Minister is satisfied that the threat resulted in economic loss to a person.

A terrorist act cannot be taken into account for the purposes of being declared if the Minister is satisfied that it is an act of war.

A declaration under this clause may also specify a reduction percentage that applies to the declared terrorist incident. In determining whether a reduction percentage is necessary, the Minister would look to whether the DTI or a series of DTIs might exhaust the resources available to the Australian Reinsurance Pool Corporation. Clause 35 of the Bill imposes an obligation on the ARPC to give notice in writing to the Minister, if it considers it likely that it will be unable to discharge all its liabilities.

By specifying a reduction percentage, the liability of insurance companies to pay claims for eligible terrorism losses is reduced by that rate. The intention behind this Clause is to ensure that insurance companies that reinsure through the ARPC are not liable for claims for eligible terrorism losses which would not be able to be reimbursed by the ARPC.

Following the initial declaration, the reduction percentage can be altered, but may only be made smaller. The effect of this is that the Minister may be quite conservative when first announcing reduction percentages.

The declaration, once published in the *Gazette*, cannot be revoked and is intended to give certainty to policyholders about whether they will be compensated for the loss arising from a particular act.

The Minister may delegate his powers to make a declaration that an act constitutes a declared terrorist incident, to the Secretary of the Department of the Treasury or an SES employee, or acting SES employee, in the Department.

Clause 7 — Eligible insurance contracts

Clause 7 sets out which contracts of insurance are eligible insurance contracts. The starting point is contracts that provide insurance cover for loss or damage to tangible property located in Australia (the underlying property), either with or without insurance cover for business interruption losses arising from loss or damage to the underlying property, or insurance cover for public liability associated with the underlying property.

This starting point will be further refined through regulations. The types of insurance coverage which will be excluded through regulations include: insurance for buildings or infrastructure owned by State or Commonwealth Governments (but not Government Business Enterprises), home & contents insurance (domestic policies), insurance for private residential property, marine insurance, aviation insurance, motor vehicle insurance, life insurance, health insurance, private mortgage insurance, medical indemnity insurance, professional indemnity insurance, reinsurance.

Insurance contracts that do not fall within the starting point definition, but are nevertheless eligible insurance contracts, will be prescribed by regulations. This provision is intended to capture public liability insurance cover that is associated with the insured property, but included in a contract of insurance separate from that defined in Clause 7(1).

The treatment of workers compensation and compulsory third party insurance schemes, and the opportunity for providers of these classes of insurance to reinsure through the Australian Reinsurance Pool Corporation, will be discussed with the relevant States and Territories.

Clause 8 — Deemed terrorism cover for eligible insurance contracts

Clause 8 deems that eligible insurance contracts that are in force at, or after, 30 June 2003 are taken to provide the same amount of insurance cover, in relation

to the underlying property, for eligible terrorism losses as the contract provides for losses or liabilities arising from other causes.

For example, if the contract provides coverage for damage caused by fire, with a monetary upper limit of \$2 million, then the effect of the deeming provision is that the insured party would now have coverage for damage caused by fire and for losses or liabilities arising from a declared terrorist incident (DTI). The monetary upper limit for losses or liabilities from a DTI would also be \$2 million.

If the contract provides different amounts payable to the policyholder and different excesses for different events or causes of damage, then the highest of the amounts payable and lowest of excesses applies to eligible terrorism losses. For example, if the contract provides for coverage for damage caused by fire (with a maximum amount payable of \$5 million and excess payable by the insured of \$200,000) and damage caused by flood (with a maximum amount payable of \$3 million and excess payable by the insured of \$400,000), then the maximum amount payable to the policyholder for losses or liabilities arising from a DTI would be \$5 million, and the excess payable by the insured would be \$200,000. (Excess is defined at Clause 3.)

In the event that it appeared that the resources available to the Australian Reinsurance Pool Corporation could be exhausted by claims under reinsurance contracts for eligible terrorism losses, the Minister, in making the declaration under Clause 6, would specify a reduction percentage to apply to a declared terrorist incident. As a result, amounts payable under eligible insurance contracts as a result of that declared terrorist incident would be reduced by the published reduction percentage. However, the reduction percentage would not apply to contracts made after startup time if the insurer was not reinsured with the Australian Reinsurance Pool Corporation.

In general, the terrorism cover will be subject to the terms of the contract in the same way as other insurance cover provided by the contract. However, exclusions or exceptions relating to the cause of a loss or liability are overridden. The effect of this is, for example, that if the contract excluded damage caused by explosions, and the Declared Terrorist Incident was perpetrated via a bomb exploding in a building, the insured party would be able to claim for eligible terrorism losses.

The deemed terrorism cover does not extend to loss or liability arising from the hazardous properties (including radioactive, toxic or explosive properties) of nuclear fuel, nuclear material or nuclear waste. Coverage under the scheme includes areas for which cover was commercially available prior to

11 September 2001. Cover for damage arising from nuclear causes has not been commercially available for many years. Government assistance in relation to damage from nuclear causes could be considered consistent with a national disaster.

Insurers will be able to reinsure for eligible terrorism losses through the Australian Reinsurance Pool Corporation (see Clause 10).

Clause 25 also includes a transitional provision. If a claim for eligible terrorism losses was made under a contract which was in force at startup time, this claim would impose a liability on the insurance company, for which the insurance company would not have had the opportunity to purchase reinsurance or to collect appropriate premium from the insured party. Clause 8(7) provides that, for those eligible insurance contracts which are in force at startup time (30 June 2003), the Australian Reinsurance Pool Corporation must compensate an insurer for any liability incurred by the insurer under the eligible insurance contract to the extent that the liability arises solely because of the operation of Clause 8. If the eligible insurance contract which was in force at startup time already included some cover for terrorism, then the obligation on the Australian Reinsurance Pool Corporation to compensate the insurance company for eligible terrorism losses would only extend to any extra liability deemed by Clause 8.

PART 3 – AUSTRALIAN REINSURANCE POOL CORPORATION

DIVISION 1 – ESTABLISHMENT, FUNCTIONS AND POWERS OF THE CORPORATION

Clause 9 — Establishment of Corporation

This clause establishes the Australian Reinsurance Pool Corporation (the Corporation).

Clause 10 — Functions of Corporation

The functions of the Corporation are specified in this clause. The primary function of the Corporation is to provide insurance cover for eligible terrorism losses. Other functions of the Corporation may be prescribed by regulations. These ‘other functions’ would be expected to relate to terrorism, for example

general compensation for losses arising from declared terrorist incidents that are not covered by eligible insurance contracts.

Apart from a retention to be specified by directions issued by the Minister (see Clause 38), the Corporation will provide 100 per cent reinsurance of the terrorism risk for insurers. Sums paid for this reinsurance cover will establish a pool of funds which will be used to pay out claims for eligible terrorism losses and to meet the administrative costs of the corporation.

It is not compulsory for insurers to reinsure the risk of eligible terrorism losses through the Corporation. Insurers might choose to accept the risk themselves, or even to seek reinsurance from a commercial reinsurer.

Clause 11 — Powers of Corporation

This clause provides that the Corporation has the power to do all things necessary or convenient to be done for or in connection with the performance of its functions. Powers include being able to charge premiums in respect of contracts of insurance, and charging fees for services.

Clause 12 — Constitution of Corporation

This clause provides that the Corporation consists of the Chair and at least four, but not more than six, other members.

The Corporation is a body corporate with perpetual succession.

DIVISION 2 – ADMINISTRATIVE PROVISIONS ABOUT MEMBERS

Clause 13 — Appointment of members

This clause provides that the Minister appoints all members of the Corporation. The Minister must not appoint a person as a member unless the Minister is satisfied that the person has suitable qualifications or experience and is of good character. Qualifications or experience that may be considered suitable include, but are not limited to, qualifications or experience in insurance, banking, property management or development, or finance. For guidance on the ‘good character’ consideration, the Minister could have regard to the test for fitness and propriety in the prudential standards issued by APRA, pursuant to s.32 of the *Insurance Contracts Act 1973*.

Notes on Individual Clauses

Members of the Corporation are appointed on a part-time basis, for a specified period not exceeding four years.

Clause 14 — Acting Chair

This clause allows the Minister to appoint a member of the Corporation to act as a Chair during a vacancy in the office of Chair or when the Chair is absent from duty or from Australia or is, for any other reason, unable to perform the duties of the office.

Clause 15 — Additional terms and conditions of appointment of members

This clause allows the Minister to determine the terms and conditions of members holding office, to the extent that those terms and conditions are not covered by this Act.

Clause 16 — Outside employment of members

This clause provides that a member of the Corporation must not engage in paid employment that, in the Minister's opinion, conflicts with the proper performance of the member's duties.

Clause 17 — Remuneration and allowances of members

This clause specifies that Council members will be paid remuneration as determined by the Remuneration Tribunal. If there is no determination by the Tribunal, the member is to be paid the remuneration prescribed. Allowances entitlements shall be as prescribed in regulations.

Clause 18 — Leave of absence

This clause provides that the Chair of the Corporation may grant leave of absence to any other member on the terms and conditions that the Chair determines.

Clause 19 — Resignation

This clause provides that a Council member may resign his or her appointment by writing to the Minister.

Clause 20 — Termination of appointment of members

This clause sets out the circumstances under which the Minister may terminate the appointment of a member of the Corporation. Circumstances include bankruptcy, absence from meetings of the Corporation, engagement in paid employment that conflicts with the performance of duties, and unsatisfactory performance.

DIVISION 3 – MEETINGS OF THE CORPORATION

Clauses 21 and 22 — Times, places and procedure of meetings

These clauses specify particular requirements pertaining to meetings of the Corporation. This includes times, places and convening of meetings; who presides at meetings; what constitutes a quorum; and the voting and conduct requirements of meetings.

Clause 23 — Resolutions without meetings

This clause provides that a resolution is taken to have been passed at a meeting of a Corporation if, without a meeting, a majority of the members indicate agreement with the resolution, in accordance with a method determined by the Corporation.

DIVISION 4 – CHIEF EXECUTIVE

Clauses 24 to 31 — Chief Executive

These clauses set out requirements pertaining to: the appointment by the Corporation of a full-time Chief Executive; the duties of the Chief Executive; appointment of a person to act as the Chief Executive; terms and conditions of appointment of the Chief Executive; the termination of the Chief Executive's appointment; leave of absence; and resignation of the Chief Executive.

The Chief Executive cannot be a member of the Corporation. The Chief Executive's appointment may at any time be terminated by the Corporation.

DIVISION 5 – EMPLOYEES AND CONSULTANTS

Clauses 32 and 33 — Employees and Consultants

Clause 32 provides that the Corporation may employ such persons as it considers necessary for the performance of its functions and the exercise of its powers.

The Corporation may also engage persons as consultants to the Corporation.

The Corporation will set out in writing the terms and conditions of engagement of employees and consultants.

DIVISION 6 – FINANCES

Clause 34 — Application of money

This Clause specifies what payments the Corporation's money is to be applied to.

Surplus money of the Corporation may be invested in accordance with Division 3 of Part 3 of the *Commonwealth Authorities and Companies Act 1997*. s.18(3) of the *Commonwealth Authorities and Companies Act 1997* states that a Commonwealth authority may invest surplus money: on deposit with a bank; in securities of the Commonwealth or of a State or Territory; in securities guaranteed by the Commonwealth, a State or a Territory; or in any other manner approved by the Treasurer. These limitations on avenues of investment of surplus money provide additional security that pool funds will be available in the event of a claim for eligible terrorism losses.

Clause 35 — Commonwealth guarantee

The Commonwealth guarantees the due payment of money that may become payable by the Corporation to any person other than the Commonwealth. The amount which the Commonwealth is liable to pay as a result of this guarantee is limited to \$10 billion.

Clause 36 — Liability to taxation

This clause exempts the Corporation from income tax under laws of the Commonwealth.

Clause 37 — Appropriation of Consolidated Revenue Fund

This clause sets out the circumstances in which the Consolidated Revenue Fund would be appropriated, i.e. to pay amounts borrowed by the Corporation from the Commonwealth, and payments under Clause 35. Note also that any payments arising from Clause 42 would also be appropriated from the Consolidated Revenue Fund.

DIVISION 7 - MISCELLANEOUS

Clause 38 — Minister may give directions to Corporation

Clause 38 provides that the Minister may give written directions to the Corporation in relation to the performance of its functions and the exercise of its powers. Directions might relate to: payments of money to the Commonwealth; entering into contracts to borrow money from the Commonwealth; entering into contracts to borrow money from persons other than the Commonwealth; premiums to be charged for insurance contracts issued by the Corporation; and retentions of risk by persons to whom the Corporation issues reinsurance contracts.

Directions relating to premiums and retentions by insureds must be published by the Minister as soon as practicable after the direction is issued. Publication on the Corporation's website would meet this requirement.

Directions pertaining to entering into contracts to borrow money from persons other than the Commonwealth cannot require the Corporation to enter into a contract with a particular person.

The power to issue directions relating to contracts to borrow money might initially be used by the Minister to direct the Corporation to make arrangements for a \$1 billion line of credit from a bank or banks, and for the Commonwealth to provide a \$9 billion indemnity to the Corporation. It is anticipated that the line of credit from the bank or banks would be drawn down by the Corporation in the event that there are insufficient funds available from premiums paid into the pool to pay claims for eligible terrorism losses. The \$9 billion indemnity would be called upon after the \$1 billion line of credit has expired. The Minister may also direct the Corporation to enter into other borrowings.

Directions might also be issued by the Minister to require payments to the Commonwealth. These payments to the Commonwealth could be in the nature

of dividends, or payments to allow the Corporation to comply with competitive neutrality principles.

Clause 39 — Evidence – Corporation’s seal

This clause states that all courts, judges and persons acting judicially must take judicial notice of the imprint of the seal of the Corporation appearing on a document, and presume that the document was duly sealed. The requirement for the Corporation to have a seal appears in Clause 12.

Clause 40 — Delegation by Corporation

This clause provides that the Corporation may delegate all or any of its powers or functions under this Act to the Chief Executive or a person employed under section 32. Note also that under Clause 25(2), a thing is taken to have been done by the Corporation if it is done in the name of the Corporation, or on behalf of the Corporation by the Chief Executive, or with the authority of the Chief Executive.

PART 4 – MISCELLANEOUS

Clause 41— Review of Act

This clause sets out the requirement for the Minister to review the need for the continued operation of this Act. Such a review will take place every three years.

Clause 42 — Compensation – constitutional safety net

Clause 42 sets out situations in which the Commonwealth would be liable to pay compensation to a person for acquisition of property otherwise than on just terms. In the event of a dispute between the Commonwealth and the person on the amount of compensation, the person may institute proceedings in the Federal Court of Australia.

Clause 43 — Regulations

This clause enables the Governor-General to make regulations for the purposes of the Act.