Australian Government

The Treasury

Terrorism Insurance Act

Review: 2015

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List of Acronyms and Abbreviations

AGA	Australian Government Actuary
ARPC	Australian Reinsurance Pool Corporation
DTI	Declared Terrorist Incident as defined in the *Terrorism Insurance Act 2003*
OECD	Organisation for Economic Co-operation and Development
NBCR	Nuclear, biological, chemical and radiological risks

EXECUTIVE SUMMARY

AUSTRALIA'S TERRORISM INSURANCE SCHEME

Background to Review

The Terrorism Insurance Scheme (the scheme) was intended as an interim measure to operate while terrorism insurance cover was unavailable in the private market. The scheme was set up under the *Terrorism Insurance Act 2003* (the Act), and is operated by the Australian Reinsurance Pool Corporation (the ARPC). The Act requires that the Minister prepare a report that reviews the need for the Act to continue in operation at least once every three years.[1] Previous reviews in 2006, 2009 and 2012 have concluded that there was insufficient commercial market terrorism insurance available at affordable rates and that the scheme should continue to operate.

The terms of reference for this review appear at Appendix A. It is not the purpose of this review to consider the level of risk of terrorism. That is the function of other branches of government. Nevertheless, recent events — in Sydney and Paris, for example — highlight that terrorism is an ongoing threat. The Sydney event in December 2014 gave rise to the first and only activation of the scheme since its inception.

This comes at a time when the scheme has been in operation more than a decade. Last year, the National Commission of Audit, in expressing a view on the future of a number of Australian Government bodies, said of the ARPC:

> "With continued recovery in terrorism insurance markets, there is scope for a gradual Commonwealth exit over the coming years."[2]

Against that background, this review has closely considered the scope for government withdrawal from the market, and whether alternative structures for the ARPC, including full or partial private ownership, would be viable. To assist in exploring these issues, an external consultant (Pottinger) was engaged by Treasury. In addition, in finalising this review, consultations were held with industry representatives on a draft of the Report.

For the reasons set out in detail in the chapters below, the recommendation of this review is that the current ownership and administration structure of the scheme as set out in the Act be retained, while noting that there is scope to revisit alternative structures in future if there is a significant change in market conditions.

Nevertheless, as the need for the scheme has persisted for more than a decade, the policy framework against which its operation is assessed should no longer be limited to one that conceives of the scheme as a short-term, temporary measure. While the ongoing need for the scheme should continue to be periodically reviewed, the fact that it has matured into at least a medium-term policy response should be recognised and reflected in decisions about the nature and scope of its operation.

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1 *Terrorism Insurance Act 2003*, section 41.

2 *Towards Responsible Government, The Report of the National Commission of Audit, Phase One, p. 205*

Reflecting the considerations outlined above, the recommendations in this report are motivated by the desire to ensure that:

- those who benefit most from the scheme — insured parties and the insurance industry – take an appropriate level of responsibility for its sustainable operation;
- the government and taxpayers are fairly compensated for any financial support provided to scheme;
- the scheme operates equitably and effectively to provide terrorism cover where it is unavailable in the private market; and
- there is an appropriate level of certainty around the operation of the scheme.

Recommendations

Structure of the ARPC

Recommendation 1: That the Act remains in force, subject to future three-yearly statutory reviews.

Recommendation 2: That the current administration structure of the ARPC as set out in the Act be retained.

Retentions

Recommendation 3: The four per cent rate of gross fire and industrial special risk premium (less any fire services levy) should be increased to five per cent.

Recommendation 4: Current maximum retention levels for individual insurers should be removed.

Recommendation 5: The maximum industry retention should be increased from $100 million to $200 million.

Retrocession

Recommendation 6: That the ARPC continue to have the discretion to purchase retrocession, subject to the APRC assessing the need for, and levels of, its retrocession programme and value for money.

Fee for the government guarantee

Recommendation 7: That the ARPC pay to the Commonwealth each year, commencing in 2016-17:

a) a fee of $55 million in respect of the Commonwealth guarantee of the ARPC's liabilities; and
b) an additional amount of $35 million per annum to reflect the Commonwealth's support in making the ARPC reserves available for payment of claims.

Premiums

Recommendation 8: That the premiums charged by the ARPC be increased, with effect from 1 April 2016 to:

- 16 per cent for Tier A,
- 5.3 per cent for Tier B, and
- 2.6 per cent for Tier C.

Scope of the scheme

Recommendation 9: That the scope of the scheme be extended so that it applies to:

a) buildings in which at least 20 per cent of floor space is used for commercial purposes; and

b) buildings with a sum-insured value of at least $50 million, whether used for commercial or other purposes.

Recommendation 10: That the application of the Act be clarified by amendments that remove doubt about whether certain losses would be covered under the scheme; in particular, losses attributable to terrorism attacks that use chemical or biological means.

CHAPTER 1: INTRODUCTION

RATIONALE OF THE SCHEME

The lack of affordable terrorism insurance following terrorism events on 11 September 2001 forced Australia's commercial property owners, developers and investors (such as banks, superannuation funds and fund managers) to assume their own terrorism risk, as existing policies expired and renewal policies explicitly excluded terrorism cover. Effects included a substantial reduction in commercial building activity. As a result, in May 2002 the Government announced that it would act to protect the Australian economy from the negative effects of the withdrawal of terrorism insurance cover.

Subsequently, a scheme was established under the *Terrorism Insurance Act 2003* (the Act) to replace terrorism insurance coverage for commercial property and associated business interruption losses and public liability claims. Under the Act, the scheme is administered by the ARPC, a Commonwealth statutory corporation. The scheme commenced on 1 July 2003.

Operation and coverage

The Act operates by overriding terrorism exclusion clauses in eligible insurance contracts to the extent the losses excluded are eligible terrorism losses arising from a declared terrorist incident (DTI).[3] This requires insurers to meet eligible claims in accordance with the other terms and conditions of their policies.

Insurance companies can (but are not required to) reinsure the risk of claims for eligible terrorism losses through the ARPC, in which case premiums are payable to the ARPC at rates set by the Minister. Insurance companies can choose to reinsure through the private reinsurance market.

An eligible insurance contract is a contract that provides insurance coverage for:

- loss of, or damage to, eligible property 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 all or part of such property; or
- liability of the insured that arises from the insured being the owner or occupier of eligible property.[4]

'Eligible property' is defined under the Act as the following property that is located in Australia:

- 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.[5]

Note that there is a range of exclusions set out in the *Terrorism Insurance Regulations 2003*.

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3 *Terrorism Insurance Act 2003*, sections 6-8.
4 *Terrorism Insurance Act 2003*, subsection 7(1).
5 *Terrorism Insurance Act 2003*, section 3.

How a claim is funded

In the event of a DTI, claims would progress along the following sequence (see also Figure 1):

1. Losses would be met first by industry up to the level of each insurer's retention; then

2. From ARPC capital up to the value of the deductible on retrocession cover; then

3. From the retrocession program, (with any co-contribution being made from ARPC capital and then through the government guarantee); and finally

4. Through the government guarantee, up to the $10 billion cap.

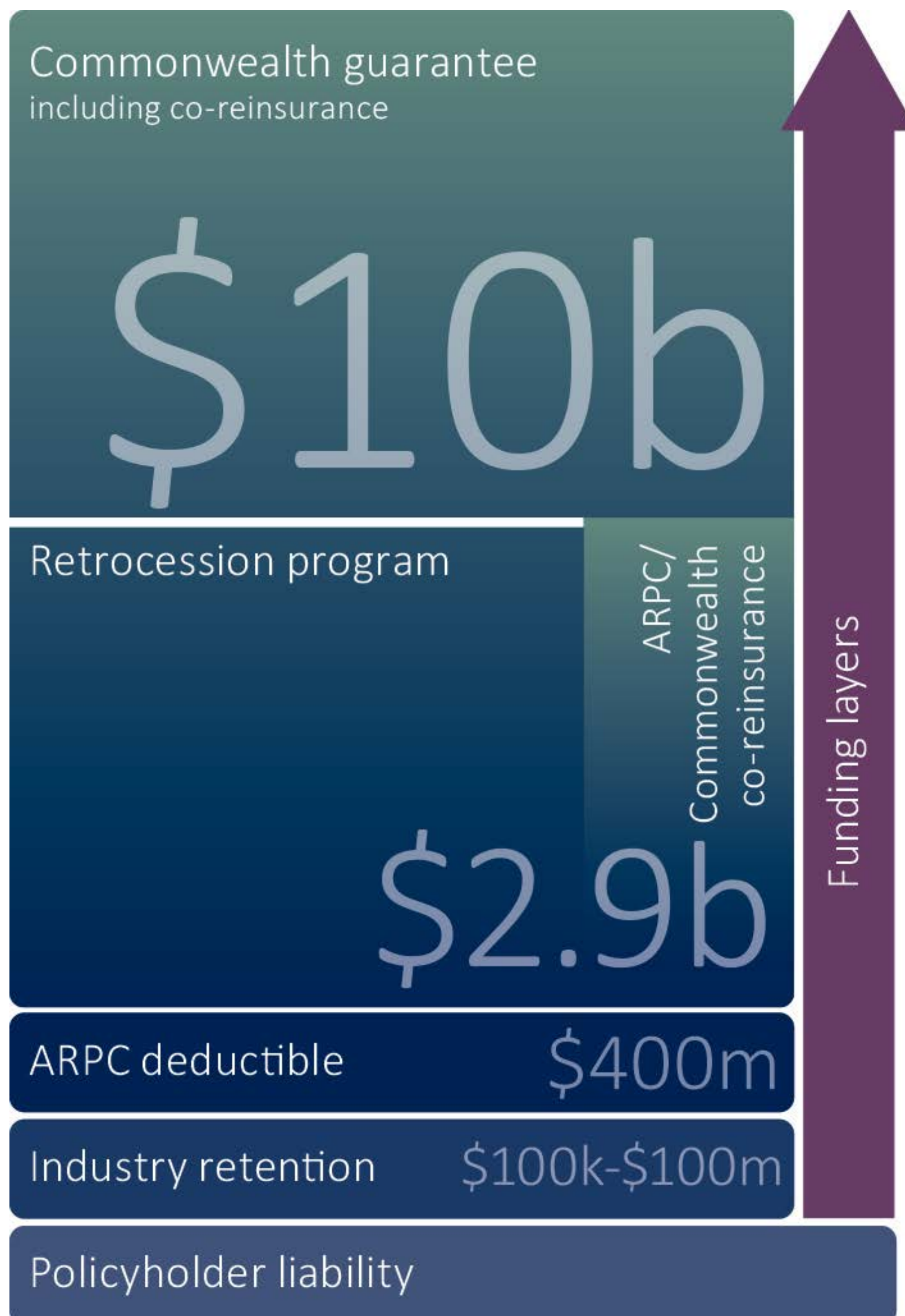
The sum of these tiers represents the maximum claimable amount under the scheme. Should the total claimed losses exceed the capital of the ARPC, the value of retrocession cover purchased and the $10 billion government guarantee, a 'reduction percentage' would be applied and claims would be paid on a pro rata basis.

Insurers that reinsure their terrorism risks with ARPC retain part of the cost from a DTI. The retention, similar to an excess or deductible, requires the insurer to pay the first part of any claim. Retentions for individual insurers are calculated as 4 per cent of fire and industrial special risk premiums collected by the insurer, with a minimum retention of $100,000 and a maximum retention of $10 million.

The ARPC's reinsurance agreement also provides for a maximum industry retention of $100 million. If the sum of the retentions of individual insurers in respect of all eligible terrorism losses caused by a single DTI exceeds the maximum industry retention of $100 million, then each insurer's retention is reduced proportionately.[6]

6 Australian Reinsurance Pool Corporation, *Annual Report* 2013-2014, page 32.

Figure 1: 2015 ARPC scheme capacity



Chapter 2: Continuation of the Act

Issue

This chapter examines whether there is a need for the Act to continue to deem cover for losses suffered due to a terrorism incident into eligible insurance contracts and whether the government should continue to provide a reinsurance scheme for this risk. Considerations include to what extent there continues to be a market failure in the provision of terrorism insurance and what the impact would be if the Act were to be abolished.

As noted above, the National Commission of Audit, in expressing a view on the future of a number of Australian Government bodies, said of the ARPC:

> "With continued recovery in terrorism insurance markets, there is scope for a gradual Commonwealth exit over the coming years."[7]

The scope for any short term Commonwealth exit is considered below.

Recommendation

The restriction on availability of terrorism insurance and reinsurance cover in the private market remains. There is some cover available, but this falls well short of the current level provided under the scheme. This is unlikely to change in the short to medium term. As a result, it is recommended that:

> *Recommendation 1*: That the Act remains in force, subject to future three-yearly statutory reviews.

In relation to the size of the scheme, the current capacity is considered an appropriate level of cover, in that modelling indicates it would adequately cover the cost of a single explosion event and provide a good level of cover for a multiple explosion event.

Assessment

Appropriate level of terrorism cover

The ARPC's modelling demonstrates that, if a loss was to occur in the Sydney or Melbourne central business districts from a large blast, ARPC's pool of funds plus the retrocession program would cover almost all probable events.[8] Multiple explosion events have not been modelled and would lead to larger losses. Determining an appropriate capacity for the scheme is challenging due to the lack of certainty of the probability of substantial events. However, the ARPC's conclusion that the current capacity of $13 billion is adequate to comfortably cover most foreseeable outcomes of a major explosion event in a large Australian city provides a basis on which to maintain the current level of

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7 *Towards Responsible Government, The Report of the National Commission of Audit, Phase One, p. 205*

8 ARPC Autumn 2013 *'Under the Cover'*.

cover under the scheme. If ARPC reserves were depleted after such an event, consideration would be given as to how best to replenish those reserves in preparation for any further event.

Market failure

The report prepared by external consulting firm Pottinger considered the availability of reinsurance for terrorism risk in detail. It concludes that the availability and pricing of private sector terrorism insurance has improved over time due to the low incidence of major terrorism claims, better risk modelling and greater competition among reinsurers. Terrorism loss reinsurance prices have also fallen over time. In addition, coverage has improved for small events.

Nonetheless, there is still a partial market failure. The Pottinger report estimates that terrorism risk retrocessions available to Australian insurers at a reasonable price total around $5 billion, which is well below the approximately $13 billion of reinsurance cover provided by the scheme.

There also seems to be no material likelihood of market conditions changing such that adequate private sector supply of terrorism insurance becomes available over the near to medium term. The development of a private market for terrorism insurance in Australia depends on further growth in the capacity of global reinsurance markets for terrorism risk. Recent developments overseas indicate that government support of terrorism insurance arrangements continues to be required. The US Parliament, for example, recently voted to reinstate the national terrorist insurance scheme, which had lapsed in December 2014. The Bill passed with bipartisan support.

Current conditions do not imply the continued availability of private sector terrorism insurance at an economic price over the medium to longer term, particularly in the event of a major claim in Australia or overseas. Further, the report indicates that, while there is increasing capacity to insure the risk pool managed by the ARPC, there is no guarantee that the same capacity would be available to individual insurers. The report identifies the risk-pooling mechanism as a key factor in providing cost-effective reinsurance of terrorism risk.

Impact on competition

A second consideration is whether continuation of the scheme is preventing the re-emergence of a private market for terrorism insurance. Again, the capacity of Australian insurers depends on the global market for reinsurance. In this context, the current government-supported scheme in Australia is likely to have little effect on the development of the market. Supporting this conclusion is the Finity report's finding that no market solution has emerged in relation to high-rise residential and mixed-use buildings not covered by the scheme.

The low impact of the scheme on the development of a market solution is consistent with the view of insurance industry stakeholders that the scheme should remain in largely its current form and is of benefit to them in a market where terrorism insurance is lacking. In fact, the successful retrocession program operated by the ARPC is viewed by stakeholders as having a positive effect on Australian insurers' access to global reinsurance markets.

Impact of removal of the scheme

A final consideration is whether the removal of the scheme would have any negative impacts.

The likely negative economic impacts are difficult to assess. There are indications from some stakeholders that removing the scheme may not initially concern the market more generally. However, conditions have not materially changed so that funding of large-scale commercial projects

would be viable without insurance. In current conditions, the pricing of the scheme suggests that insurers see little likelihood of a large-scale loss. Yet there seems to be no reason to think that a future large terrorist event would not have a similar effect on large commercial building activity to that in 2001.

A further issue is that, if sufficient terrorism insurance is not available in the private market, then the government may be called on to provide open-ended support in the event of a terrorist incident. Existence of an explicit guarantee provides certainty and enables the government and tax payers to be fairly compensated for the provision of the guarantee.

The need for the scheme was highlighted recently through the certainty it provided in the December Sydney siege events where it was activated for the first time. Although losses are predicted to be below the level of activation of the government guarantee, the scheme has provided a mechanism for communication between insurers and the government and provided certainty to claimants.

Ongoing reviews

The Pottinger report recommends making the scheme permanent given the apparent ongoing need for the Act, and posits reviews once every 5 years. While this review recognises that the temporary nature of the scheme needs to be reassessed given the persistent need for it, it is considered that triennial reviews should remain in place to ensure that the ongoing need for the scheme is closely monitored, but also to ensure that the parameters of the scheme are appropriately set.

CHAPTER 3: OWNERSHIP STRUCTURE OF THE ARPC

ISSUE

While the Act and the ARPC are necessary and likely to be so over the longer term, there may be alternative options available for ownership of the ARPC. This chapter considers alternative options for the ARPC and whether the ownership or administration structure should be changed.

RECOMMENDATION

> *Recommendation 2*: That the current administration structure of the ARPC as set out in the Act be retained.

ASSESSMENT

The introduction of the scheme in 2003 was to counter a significant impact on economic activity due to a lack of insurance for commercial property and associated business interruption losses and public liability claims. At the time, it was recognised that creation of the ARPC, a government-owned statutory corporation, would increase government involvement in the insurance market, operate as a competitor to private-sector reinsurers, and increase the risk faced by the government through the provision of a government guarantee. For these reasons, the scheme was intended to be temporary until a market-based solution re-emerged.

This review finds that there is no near-term possibility of a market-based solution emerging and that the scheme should continue. However, the review also considers whether there is scope for alternative ownership or administration structures for the ARPC that might increase industry responsibility for the scheme's continued operation, and facilitate a gradual withdrawal from the market by the government. An external consulting firm, Pottinger, was engaged by Treasury to provide advice on alternatives for this review (report attached as Annex A).

Pottinger's report canvasses ownership and administration structures used for similar schemes overseas and considers costs and benefits if these options were to be adapted for use in the Australian context. Drawing on Pottinger's work, this review considers two broad alternative options for ownership of the ARPC that would allow for significantly lower government involvement: a private sale and a mutual structure. If one of these options were to be pursued, a transition plan would need to be established to ensure the success of the transfer.

Both options presented here retain a mechanism to pool risk. Terrorism risk is different to other insurable risks as the potential loss from a single event is very high, events happen at very low frequency and are unpredictable, and the actions of the government can have an impact on the probability of an event. The Pottinger report concludes that a risk pool, such as the one operated by the ARPC, is the most cost-efficient way to provide access to retrocession markets. The report

concludes that the same level of retrocessions may not be available to individual insurers outside a risk pool.[9] This view was reinforced in consultations with the industry.

Both options also contemplate the continuation of the government guarantee. The Pottinger report estimates that the private sector currently can provide only $3 billion — $5 billion in retrocession coverage for terrorism risk in Australia, below the current size of the scheme and the estimated maximum losses under a single large terrorist incident. In the event of a terrorist incident where losses exceeded those covered by the private sector, it is likely that the Government would be called upon to provide additional financial support. An explicit government guarantee reduces uncertainty, decreases insurance premiums, and ensures that the government receives adequate compensation for the risk faced in acting as an insurer. Most foreign schemes have some form of government support.

Sale of the ARPC by trade sale or initial public offering

A private sale of the ARPC has the potential to reduce government involvement and risk taken by the government, as well as realising value for the government that is currently tied up in the ARPC. The government could seek to retain majority ownership through a limited share offer or pursue full privatisation.

Establishing a likely purchase value for the ARPC is difficult without exact knowledge of how the scheme would operate after a sale. The factors to be considered include how much control the private entity would have over premiums and the ability of the purchaser to diversify risk; market sounding reports suggest that few market participants would be interested in purchasing an insurer that only covered terrorism risk. The value would also be affected by any minimum prudential capital requirements that might be applied, required provisions for charges following a major claim, and whether the Act will continue to deem insurance cover for losses caused by terrorism incidents into eligible contracts.

If the scheme settings remain as they are, Pottinger considers that private sector buyers would place little value on the ARPC. The Pottinger report estimates that the current premium and cost structure of the ARPC would generate a return on equity below that of other listed insurers. The potential purchaser may also be required to inject capital into the ARPC to meet prudential capital requirements if the ARPC was privately owned, lowering the value to a potential purchaser.

While the settings of the scheme can be changed to facilitate a sale, a clear transition plan to establish and maintain the value of the ARPC would be required.

A significant policy issue is that a privately-owned ARPC would likely operate as the sole provider of terrorism reinsurance in Australia. Creation of a systemically important financial institution operating as a monopoly provider of terrorism reinsurance may trigger financial system stability concerns. In particular, it may be necessary to identify how the entity would recapitalise after a large claim. Privatisation may also impact on the prudential capital requirements of insurers reinsuring with the ARPC.

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9 The Pottinger report examines alternative options which do not involve pooling in Section 6.7 of their report.

Transfer to a mutual structure

A second option is for the ARPC to adopt a mutual structure. Members could be either the property insurers or the insured property holders. An international precedent exists for a mutual structure owned by insurers - the UK Pool Re scheme.

Mutualisation of the ARPC offers several advantages. It could increase industry involvement and responsibility and align incentives between the administrators of the scheme and those who benefit from the availability of terrorism insurance. The private sector would also take a much larger role in operating the scheme, reducing the administrative burden on the government. However, mutualisation is unlikely to reduce the risks faced by the government. As discussed, for the capacity of the scheme to be maintained, a government guarantee would be required. Existing mutual schemes overseas also receive government support.

Again Pottinger considers that clarification of uncertain aspects of the scheme would be required before the scheme could be mutualised. This list includes clarification of the regulatory framework for the mutual structure and any regulatory capital requirements; the mutual entity's ability to set prices; the process for recapitalisation after a large claim; the nature of the government guarantee; and the coverage of the scheme. In addition, the governance and voting rights within a mutual would need to be considered to ensure the appropriate balance of interests between stakeholders. A comprehensive transition plan would be required to ensure the success of any mutualisation.

Mutualisation would not necessarily release capital to the government. The Pottinger report argues that a mutual structure may be subject to prudential capital requirements or may wish to hold capital in a similar way to a private entity. One implication is that it may be necessary for the government to 'gift' the existing capital to the scheme without compensation.

Assessment

The options outlined above may be viable in the longer term but do not present as attractive short-term solutions. None of the viable options identified by Pottinger involve complete withdrawal of government support, and would require major adjustments to the scheme, including heavily increasing the burden on the users of the scheme, if they were to release capital to the Commonwealth.

The current administrative structure is well established and provides terrorism insurance that cannot be provided to the same degree in the private market. In addition, the current scheme provides a high level of cost-effective access to international reinsurance markets for terrorism risk, with the ARPC being able to build a sizeable retrocession program. Market participants widely support the continuation of the current scheme in its structure and operation.

Following the events at the Lindt Café in Sydney in December 2014, the scheme provided certainty to claimants and allowed for effective communication between industry and the government. Government control of the scheme ensures that the scheme will continue to be operated in the public interest, including in the event of a large claim.

Against this background, there appears to be no compelling case for a major change in the ownership or administration structure of the ARPC in the short term. If market considerations change, further consideration could be given to these options. The appropriate next step would be to undertake a comprehensive scoping study to further consider the viability of alternative options

and set out an implementation plan for a preferred option. In the meantime, greater private sector participation can be encouraged by adjustments to the scheme parameters as set out in this review.

The Northern Australia Insurance Premiums Task Force is assessing the feasibility of a reinsurance pool for cyclone risk, among other options. Its interim report notes that the ARPC could potentially be used to offer a cyclone reinsurance contract (although the cyclone and terrorism pools would need to be completely segregated from each other).

Chapter 4: Ensuring Financial Sustainability of the Scheme

Although introduced on a temporary basis, the Act has been required to operate over a longer period than initially contemplated. The current pricing of the government guarantee and premiums, as well as settings relating to the purchase of retrocession and retention levels, should be reviewed to ensure the scheme is sustainable over the medium term and that industry takes an appropriate level of responsibility.

This chapter considers:

- the level of industry retentions;
- the purchase of retrocession by the ARPC;
- the fair level of compensation received by the government for the provision of the $10 billion guarantee and the retention of capital by the ARPC; and
- the appropriate level of premiums.

Industry retentions

Issue

Whether:

- the current level and structure of retentions that apply to individual entities that reinsure with the ARPC are appropriate;
- the overall industry retention per incident is appropriate; and
- increasing this retention would encourage insurers to seek out reinsurance privately.

Recommendations

Recommendation 3: The four per cent rate of gross fire and industrial special risk premium (less any fire services levy) should be increased to five per cent.

Recommendation 4: Current maximum retention levels for individual insurers should be removed.

Recommendation 5: The maximum industry retention should be increased from $100 million to $200 million.

Background

When the scheme began in 2003, the Act required insurers who bought reinsurance from the ARPC to retain risk at a minimum of nil and a maximum of $1 million, with the maximum industry wide retention set at $10 million. Retentions were based on 4 per cent of the reinsured’s gross fire and industrial special risk premium less any fire service levy.

The 2006 review of the Act recommended that, as the insurance industry had developed, retentions under the scheme should increase to a minimum of $100,000 and a maximum of $10 million, with an industry retention of $100 million. Retentions were gradually increased as a result. The 2012 review of the Act recommended no change to retention levels.

Assessment

An analysis of ARPC's portfolio indicates that five insurers benefit from the $10 million maximum retention and many insurers would have a retention of less than $100,000 if the minimum was not applied. That is, smaller insurers are made to retain more than 4 per cent of relevant premiums, yet large insurers have their retention capped under the current arrangements at less than 4 per cent.

Further, some consolidation of insurance licenses has led to a situation where some insurance groups have effectively reduced their maximum exposure under the scheme by reducing the number of insurance companies they own that are subject to an individual cap of $10 million.

The ARPC advises that insurer's retentions under the ARPC's terrorism reinsurance agreements are much lower than those used in natural catastrophe reinsurance, even though the ARPC retentions are more generous in that they are the maximum retention per year rather than per event.

Based on the above, the case can be made for increasing the retention level and removing the maximum individual retention in ARPC agreements to ensure that the insurance industry takes an appropriate level of responsibility in the event of a major claim under the scheme. Removing the maximum retention will also ensure a more even distribution of retention burden. Minimum retentions should be maintained to ensure that insurers retain a non-trivial level of responsibility under the scheme.

One of the underlying principles of the scheme is that it should be designed to allow the re-emergence of the commercial market for terrorism risk cover. Raising retention levels requires insurers to retain a greater amount of terrorism risk, for which they can self-insure or seek to commercially reinsure. Either course of action increases private sector involvement in the provision of terrorism risk cover. Increasing retentions also increases the relative attractiveness of commercial terrorism reinsurance.

Continuation of Retrocession Program

Issue

Whether the ARPC should continue to have the discretion to purchase retrocession in the private market.

Recommendation

> *Recommendation 6:* That the ARPC continue to have the discretion to purchase retrocession, subject to the APRC assessing the need for, and levels of, its retrocession programme and value for money.

Background

For the first six years of the scheme, the ARPC did not purchase retrocession. Instead, premiums were used to build capital within the ARPC to extend the size of the scheme and provide a buffer before the unfunded government guarantee was called upon. However, once sufficient capital had built up within the scheme, the ARPC was given the discretion to purchase additional retrocession cover from the private market.

The ARPC has purchased retrocession every year since 2009. It initially provided cover of $2.3 billion, but this amount has increased over time to a maximum of $3.2 billion in 2014. In 2015, retrocession cover was slightly lower at $2.9 billion.

Assessment

The purchase of retrocession creates a role for the private market in providing terrorism insurance under the scheme and ensures that the insurance of private sector assets is provided to the greatest degree possible by the private market. A strong argument can be made in support of continuing the retrocession program, in that it:

- supports the private sector provision of terrorism insurance and reinsurance;
- provides an indication of both the market price for terrorism insurance and the availability of terrorism reinsurance in the private sector;
- increases the overall capacity of the scheme (currently by around $3 billion); and
- reduces the risk that the government guarantee will be called upon.

During consultation, industry stakeholders did not express particular views on the ARPC's retrocession program. Insurers generally benefit under current arrangements; the purchase of retrocession by the ARPC increases the size of the scheme and, therefore, the amount of reinsurance cover purchased by insurers.

On balance, it is prudent for the ARPC to maintain its retrocession programme, at a level that represents the best value for money having regard to the ARPC's other commitments, to ensure that the private reinsurance market for terrorism cover continues to operate in Australia, and to give information about the availability and price of private terrorism reinsurance. This approach would assist in a government withdrawal from the market in future if conditions improved.

COMPENSATION TO GOVERNMENT

Issue

Whether and to what extent the government should be compensated for the financial benefits it provides to the ARPC.

Recommendation

Recommendation 7: That the ARPC pay to the Commonwealth each year, commencing in 2016-17:

a) a fee of $55 million in respect of the Commonwealth guarantee of the ARPC's liabilities; and

b) an additional amount of $35 million per annum to reflect the Commonwealth's support in making the ARPC reserves available for payment of claims.

Background

The ARPC is not a mutual pool. It is a government owned reinsurance agency that provides reinsurance cover to industry on the same basis as that provided by commercial reinsurers. The premiums charged by the ARPC represent compensation for the risk of a claim occurring during the period of insurance. The government bears considerable risk in the event of a claim. In the first instance, the government's equity in the ARPC would be reduced as claims are paid out of its pool. Further, in the event of a large claim that exhausts the capital retained in the ARPC and any retrocession purchased by the ARPC, the government will be called upon to cover losses.

Since its inception, the ARPC has been backed by a government guarantee of the ARPC's liabilities to the amount of $10 billion. From the scheme's commencement, it was intended that the Commonwealth be compensated for the risk it assumed in providing its guarantee. As outlined in the Revised Explanatory Memorandum to the Terrorism Insurance Bill 2002, the intention was "that risk transferred to the Commonwealth is appropriately priced and that the Commonwealth is compensated by those benefiting from the assistance".

Initially no charge was made for the Commonwealth's assistance to the scheme, allowing income from premiums to be used to build up capital within the ARPC as a reserve fund to act as a buffer against a claim on the government guarantee.

Nature of Government Support

In determining a fair amount of compensation for government support to the ARPC, it is instructive to consider the nature of that support. It is open to the government to raise premiums at any time, including following a DTI and subsequent claim on the scheme. This does not, however, have the consequence that the scheme is intended to be a 'post-funded' one in the sense that stakeholders would be required to 'repay' funds expended by the Commonwealth as a result of the guarantee. The ARPC provides reinsurance to insurers and is not able to demand repayment of any claims made on it. Similarly, the support provided by the Commonwealth as guarantor is in the nature of reinsurance rather than temporary liquidity.

Post-funding would be similarly complicated by the fact that the scheme as it currently stands is not compulsory, so that any increase in premiums following an event may result in insurers looking for retrocession cover outside the ARPC scheme. In this regard, the terrorism insurance scheme stands in contrast to the Financial Claims Scheme, for example, which *imposes* a levy on industry, if required, in the aftermath of the failure of a financial sector entity. While flexibility remains for ARPC premiums to increase following a large claim, insurers are not compelled to reinsure with it.

The result is that the support provided by the government guarantee is akin, if not identical to, retrocession cover, and this is an appropriate starting point for assessing the amount of compensation that should be paid to the Commonwealth.

Assessment

From the 2012-13 fiscal year, the ARPC began to compensate the government for the guarantee and this has continued to the time of this review. The current compensation arrangements are split into a fee and dividend: the fee represents a reasonable annual charge for the guarantee ($55 million), while the dividend ($57.5 million) provides retrospective compensation for the years that taxpayers were not compensated for providing the guarantee. The dividend is set to cease after 2017-18. A study by the AGA put the value to the ARPC (and those it reinsures) of the guarantee over this period

(having regard to the background as set out above) at least $800 million. The task of this review is to assess an appropriate and sustainable level of compensation for the ARPC to pay to the Commonwealth on an ongoing basis.

Pottinger estimates that, if the ARPC was to replace the government guarantee with private retrocession of $10 billion in the private market (if it was available), this would cost around $200 million annually. This estimate assumes the premium paid by the ARPC would be equal to the marginal rate on line for the ARPC's retrocession program in 2014. Pottinger argues that this rate is the minimum rate at which the private sector *could* provide retrocession.

The AGA provides an intentionally more conservative estimate of the value of the guarantee to the ARPC of around $55 million, significantly below the charge the Pottinger report estimates would be applied by a private sector reinsurer. This estimate assumes the first dollar of cover provided under the guarantee could be priced at the marginal rate on line of the retrocession programme, but that reasonable fee falls for each additional dollar of the guarantee provided. In effect, the AGA's valuation implies zero charge for the last $3 billion of the guarantee. The end result is a fee below the private sector charge as the government does not have to achieve 'market returns'.

To date, the government has received no compensation for allowing the ARPC to retain capital to fund a potential claim, even though the ARPC has built up a significant pool through its reinsurance operations. Pottinger estimates that the cost to the ARPC to reinsure the first $360 million of losses in the private market, which would currently be funded using the capital retained by the ARPC, would be between $30 million and $70 million. A similar value of $35 million is obtained by the AGA based on the ARPC holding a capital pool of $500 million. Both of these calculations draw on actual premiums paid by the ARPC for retrocession.

Given the principle that the government should be fairly compensated for taking on the risk, a fee or dividend consistent with the AGA's more conservative estimate of $35 million is considered more appropriate than a full commercial rate. This fee represents fair compensation for the provision of around $500 million in government funds in the form of the pool and reserves.

Coupled with the fee of $55 million for the $10 billion guarantee, this equates to an ongoing annual compensation amount of $90 million payable by the ARPC to the Commonwealth.

Compensation at this level still allows the ARPC to offer cover at below the rate that could be provided by the private sector. This is considered appropriate unless or until there is evidence that suggests this impedes the return of the private market to provide reinsurance cover for terrorism.

The assessment of the value of the government guarantee set out above assumes retrocession cover continues to be purchased at around the current level. If the retrocession program were reduced in size, the value of the guarantee would rise in line with the increasing risk that the guarantee would be called upon and the fee would need to be reviewed.

An implication of the higher compensation to the government is that the ARPC will need to raise additional premiums. This is discussed in more detail below.

PREMIUM PRICING

Issue

Whether current premiums:

- adequately reflect the cost of providing the terrorism reinsurance scheme; and
- in any way impede a competitor from providing terrorism reinsurance in Australia.

Recommendation

Recommendation 8: That the premiums charged by the ARPC be increased, with effect from 1 April 2016, to:

– 16 per cent for Tier A,

– 5.3 per cent for Tier B, and

– 2.6 per cent for Tier C.

Background

Insurers who seek terrorism reinsurance through the ARPC pay premiums to the ARPC, although insurers may choose to reinsure with other providers. Insurers may pass on the cost of reinsurance to their policy holders through premiums, although this is a commercial decision for the insurer.

When the scheme was first established, it was considered that reinsurance premiums of between 2 and 12 per cent of underlying commercial property insurance premiums would be adequate to build the pool (reserves for claims) and would not be a significant cost to smaller commercial property owners if passed on by insurers. The premium levels (as a percentage) have remained unchanged since 1 October 2003.[10]

Assessment

Two broad questions emerge in relation to whether the current premiums adequately reflect the cost of providing terrorism insurance: firstly, is the level of the premium sufficient and, secondly, is the mechanism for calculating the premiums appropriate?

The Pottinger report concludes that premium rates currently charged under the scheme are materially lower than implied by the cost of terrorism risk retrocessions purchased by the ARPC from the private sector. It estimates that, if the ARPC set premiums in line with the price of retrocessions, premiums could rise by over 100 per cent of current levels. The report further notes that the current premiums were set before there was a reasonable estimate of the cost of reinsurance (or retrocession) in the private market.

[10] Tier A is CBDs of cities with populations over 1 million.
Tier B is urban areas of all State capitals plus cities with populations over 100,000 eg Newcastle, Geelong, Wollongong.
Tier C is all other areas of Australia

Pottinger's assessment could therefore underpin a doubling of current reinsurance premiums charged by the ARPC. This is not, however, the result recommended in this review. The principal determinant of the marginal price for reinsurance/retrocession in the private market is the cost of capital of the reinsurers concerned. Given that the government does not need to achieve 'market returns', it is not considered unreasonable that the charges levied by the government through the ARPC are lower than those that would be set by the private sector for reinsurance.

At this stage, it is unlikely that the premium settings are currently restricting competition or the development of a private market for terrorism risk (see Chapter 2), although the potential for a private market to re-emerge, and any effect ARPC premium rates have on this, should continue to be monitored.

Nevertheless, the ARPC must generate sufficient premiums to cover its ongoing costs and ensure that those who benefit from the scheme share an appropriate burden of the cost. At current levels, the premiums appear sufficient to cover operational costs, to cover the fee for the government guarantee and to purchase a degree of retrocession cover while maintaining the capital pool at around current levels. However, the current level of premiums is not enough to provide a return on the equity held by the ARPC that will be used as the first tier of funding in the event of a claim. An increase in the premium pool is, therefore, recommended.

The second question is whether the mechanism for calculating the premium is appropriate. This is the practice of setting premiums as a percentage of gross fire and industrial special risk premiums charged by the insurer and of using a community rating. Potential alternatives exist, including pricing premiums based on a larger number of criteria than only location and setting premiums as a proportion of the sum insured.

The Pottinger report considers that some level of community rating is appropriate in the context of the terrorism insurance scheme. The current system balances the need to take into account certain risks, such as geographical location, while maintaining a simple system that is well-established and understood by stakeholders. Setting premiums for properties using a more complex calculation of the risk attached to each property would raise costs significantly, without necessarily implying that the premiums charged would accurately reflect the risk taken on by the ARPC. Setting premiums as a proportion of the gross fire and industrial special risk premiums links the ARPC's premiums to conditions in the wider insurance market and is a simple mechanism to allow premiums to increase over time with property values.

It is, therefore, proposed that the ratios between the premiums under the current tiered structure be maintained, but that the level of premiums be increased with effect from 1 April 2016 to ensure the ARPC can remain self-funded over the medium term while reasonably compensating the Commonwealth and maintaining an appropriate level of capital.

In consultations with the insurance industry on premiums, a number of parties expressed a view about calculating premiums as a percentage of the insured value of the asset. Adoption of this method of calculation would give the ARPC a more stable funding base as it would overcome the cyclical nature of insurance premiums and make ARPC's funding smoother.

Further consultation should be undertaken with insurers to assess the likely impact of such a change, including compliance costs, on their systems and processes, with a view to considering the adoption of this methodology at a later date.

CHAPTER 5: CLARIFYING THE COVERAGE OF THE SCHEME

MIXED-USE AND HIGH-RISE RESIDENTIAL BUILDING COVER

Issue

Whether the scheme should be extended to cover 'mixed use' buildings and high value residential buildings.

Recommendation

Recommendation 9: That the scope of the scheme be extended so that it applies to:

a) buildings in which at least 20 per cent of floor space is used for commercial purposes; and
b) buildings with a sum-insured value of at least $50 million, whether used for commercial or other purposes.

Background

The scheme set up by the Act was intended to cover commercial property. The rationale for confining the scheme to commercial property is set out in the Explanatory Statement to the Terrorism Insurance Regulations:

> An assessment of the Australian insurance market by Trowbridge Consulting, assisted by Chiltington International, in June and July 2002 found that virtually no terrorism-related insurance cover is available for commercial property and business interruption. The Government therefore decided that its replacement terrorism insurance scheme should cover commercial property.[11]

This decision was given effect by excluding policies that cover losses to property that is used wholly or predominantly for personal, domestic or household purposes by the insured.[12]

At each review of the Act, the scope of the scheme has been reviewed. One consistent call from stakeholders has been that consideration should be given to extending the scheme to certain classes of residential buildings. Most recently, the question was considered in the 2012 Review, which declined to recommend that the scope of the scheme be extended. It did, however, recommend that the issue be re-examined at a later stage.

Past reviews have come to the conclusion that the scheme should not be extended to any class of predominantly residential building primarily because there was no evidence to suggest that the lack of coverage for that kind of property was not having an acute economic effect in the same way the lack of coverage for commercial property had in the lead-up to the establishment of the scheme. Against a background where the scheme was established to address that specific economic effect

11 *Terrorism Insurance Regulations 2003*, No. 162, Explanatory Statement.
12 *Terrorism Insurance Regulations 2003*, regulation 7 and Schedule 1, paragraph 2(d).

and was intended to exist only for as long as needed, the conclusion in past reviews has been not to extend the scheme. That view is re-examined in this review.

Assessment

This review has concluded that, after more than a decade in operation, the scheme should continue for the foreseeable future. As the need for the scheme persists, arguments that appeal to its temporary nature become less convincing, and the need to deal with potentially inequitable results if a major terrorist act were to occur becomes more pressing.

A study by Finity Consulting, undertaken for the purposes of this review (Annex B), has indicated that there are still classes of buildings for which terrorism cover is unavailable in the private market (and currently unavailable under the terrorism insurance scheme). These are buildings with between 20 per cent and 50 per cent commercial floor space, and buildings with a sum insured value of at least $50 million, whether used for commercial or other purposes.

If a major terrorist event were to occur, the result could be that buildings in close proximity were treated differently under the Act due to variations in the nature of the buildings' use. The result would be that owners of some buildings would be dealt with in an orderly fashion under the scheme, while others would be left to appeal to governments for assistance in a less structured way.

The government currently recovers no compensation for the risk that it may be called upon to cover those outside the scheme. Expanding the scheme enables the government and tax payers to be suitably compensated for bearing that risk.

A large majority of respondents to the market soundings exercise conducted by Pottinger recommended broader coverage of predominantly residential mixed-use buildings by the terrorism insurance scheme. Respondents indicated that they considered the exclusion of these buildings from the scheme to be inequitable. The view was expressed that, should a terrorist attack cause material damage to a building that is not covered by the scheme, the government would be likely to come under pressure to provide financial support to the affected parties. It was thought that including such buildings in the scheme would allow the government, through the ARPC, to collect insurance premiums in advance of such an event.

Finity's 2014 analysis of the impact of including mixed-use and high-rise residential buildings in the scheme focused on buildings located in Sydney and Melbourne Tier A postcodes. Finity found that including existing mixed-use and high-rise residential buildings in these locations in the scheme would increase the total sum insured by the ARPC in those locations by approximately 1.2 per cent and 9.7 per cent, respectively. Finity examined the impact on the premiums received by the ARPC of including mixed-use and high-rise residential buildings in the scheme. It was found that, across all Tier A postcodes in Australia, including existing mixed-use buildings would increase premium income by between $100,000 and $200,000 per annum, while including existing high-rise residential buildings would increase premium income by between $700,000 and $1.4 million per annum.

Finity also concluded that, while including mixed-use buildings in the scheme would not significantly change the government's exposure, the inclusion of high-rise residential buildings would generally increase the government's exposure; for some key risk locations, including high-rise residential buildings would significantly increase the government's exposure to losses from a declared terrorist incident.

This review recommends that the scheme be extended to cover buildings of those classes where terrorism insurance is unavailable in the private market.

IMPACT OF EXCLUSIONS IN INSURANCE POLICIES

Issue

There is some uncertainty in the insurance and reinsurance markets as to the effect of some exclusions in eligible insurance contracts. For example, some stakeholders expressed the view that general exclusions in insurance contracts may, despite the application of the Terrorism Insurance Act, remain effective to exclude liability to pay claims.

Recommendation

> *Recommendation 10:* That the application of the Act be clarified by amendments that remove doubt about whether certain losses would be covered under the scheme; in particular, losses attributable to terrorist attacks that use chemical or biological means.

Assessment

Once a terrorism incident has been declared, the Act operates to render terrorism exclusions in eligible insurance contracts of no effect. Section 8 of the Act defines a terrorism exclusion as: an exclusion or exception for acts that are described using the word 'terrorism' or 'terrorist' or words of similar effect; or other acts that are substantially similar to terrorist acts as defined in Section 5 of the Act.

Many insurance contracts contain a range of exclusions (general exclusions) that exclude cover for losses from things like: chemical, biological and nuclear explosion, pollution or contamination; the destruction of electronic data; or the effects of micro-organisms. Doubt has arisen as to whether such exclusions constitute terrorism exclusions as defined by the Act.

This is because these exclusions do not use words like 'terrorism' or 'terrorist' or other words that specifically refer to events like terrorism, but rather merely exclude losses of a particular class of event.

If this view is correct, losses of a particular class could be effectively excluded even where they came about as the result of events declared to be terrorist incidents under the Act. Take, for example, the release of a toxic chemical agent in such circumstances that caused the event to be declared a terrorist incident under the Act. On one view, a clause that purported to exclude damages caused by the release of chemical agents, but made no mention of terrorism or like terms, would remain effective to exclude the insurer's liability to pay claims for losses caused by the event.

The uncertainty over whether general exclusions would be voided by the Act has created a lack of clarity over the coverage afforded by the terrorism insurance scheme.

When the scheme was introduced in 2003 it was the intention of the (then) Government that a terrorist event using chemical and biological means should be covered.

Chemical and biological attacks are covered in most international pools.

In its report, Pottinger recommended that the government provide clarity in relation to any restrictions that apply to the cover provided by the scheme, as uncertainty over the extent of cover may create both economic and political risks.[13]

In the market soundings exercise conducted by Pottinger, there was strong support from respondents for clarifying the coverage of the scheme in relation to chemical and biological means of attack. Some responses from reinsurers to this exercise also highlighted the lack of clarity over the impact of general exclusions on the coverage of the scheme. Some reinsurers indicated that they would expect losses from biological and chemical hazards associated with terrorist attacks to be excluded from the scheme's coverage, through the operation of general exclusions in insurance contracts, while others expressed the opposite view. Should such an event occur the uncertainty surrounding the extent of cover provided by the ARPC would potentially create both economic and political risks.[14]

If the government was to clarify, through legislation, the coverage of the terrorism insurance scheme, this would require careful consideration of both the operation of general exclusion clauses, and whether losses from certain types of declared terrorist incidents should be explicitly excluded from coverage in the same manner as losses from nuclear hazards. Detailed consultation with stakeholders would be needed on these issues.

The Review recommends that the lack of clarity surrounding exclusion for terrorist attacks using chemical or biological means be resolved as soon as possible.

[13] Pottinger Report, page 76
[14] Op cit, page 82

APPENDIX A: TERMS OF REFERENCE

Treasury will report to the Minister on:

- Whether there continues to be market failure in the private sector supply of terrorism insurance and, consequently, whether there is a need for the Act to continue in operation;
- Options on the future of the Act, including if there are possible alternative modes of ownership of the ARPC available to the Government and the costs and benefits of each alternative;
- Whether the pricing of the scheme (the premium rates and tier structure), the level and structure of insurer and industry retentions, and the purchase of retrocession cover (including its level and cost) continue to be appropriate and do not distort demand for insurance;
- Whether the operation of the scheme should be extended to include mixed commercial and residential use buildings, and high-rise residential buildings; and
- Whether refinements to the scheme are necessary to clarify coverage for biochemical attacks, having regard to the effect of insurance policy exclusion clauses such as Chemical, Biological, and Pollution exclusions.

In conducting the review, Treasury will incorporate input from an expert external consultant. The consultant will be instructed to provide a written report to Treasury.

APPENDIX B: INTERNATIONAL APPROACHES

Many developed countries have national terrorism insurance systems in place. Countries with a history of terrorism tend to have long-standing government-run terrorism insurance schemes. For example, the Spanish scheme was established following the Spanish Civil War; the South African scheme was set out following the political unrest of the 1970s; and the Israeli scheme was started early in Israel's statehood.

In the early 1990s, the UK Government and the UK insurance industry set up the Pool Reinsurance Company Limited (Pool Re) scheme. The scheme was designed to deal with a market failure for the provision of terrorism insurance following terrorism incidents related to the troubles in Northern Ireland and the flow-on effects of a lack of insurance on the UK economy.

A large number of schemes were set up following the September 11 terrorist attacks, including in Austria, France, Germany, India, the Netherlands, Switzerland, the United States and, of course, Australia.

RECENT DEVELOPMENTS IN THE UNITED KINGDOM AND UNITED STATES

In the English-speaking world, there has been a push to make the insurance industry pay more for government guarantees, as well as to increase the amount of risk borne by the industry.

The UK Government recently announced changes to the UK scheme that push their scheme's costs towards the insurance industry and away from taxpayers. For example, it will charge Pool Re (the UK scheme) a fee for the UK Government guarantee of the equivalent of 50 per cent of premiums, in addition to a dividend payment of 50 per cent of any surplus generated, half of which will go to the UK Government and half of which will be paid to members of Pool Re. The UK Government also recently announced that Pool Re will be permitted to seek retrocession cover.

In the US, the federal terrorist risk insurance scheme was recently reinstated after the scheme briefly lapsed due to delays in getting the bill passed in Congress. Some changes to the scheme push more of the responsibility onto industry in the event of a terrorist attack. The changes raise industry retentions in the event of a claim, for example, by 2020, the amount of an incident that triggers the government scheme will need to be $200 million, with co-insurance from the insurance industry increased to 20 per cent.[15]

Towards the end of 2014 and into early 2015, the US scheme faced uncertainty because it was not clear whether the US Congress would extend the scheme. Full effects on the US economy and businesses were not felt in this short lapse as many businesses did not wish to publicise the nature

15 Guy Carpenter, *'A Comparison of the Federal Terrorism Insurance Backstop Legislation'*, 8 January 2015.

of their vulnerability in the absence of TRIA.[16] However, no major cancellations of building projects or events are known to have occurred.[17]

Part 3.8 of the attached report by Pottinger discusses some of the recent developments in international terrorism schemes.

HOW THE AUSTRALIAN SCHEME COMPARES WITH OTHER SCHEMES

The Australian scheme is similar to terrorism insurance schemes in other Organisation for Economic Co-operation and Development (OECD) countries, with some combination of a pool, reinsurance and a government guarantee, especially those established after the 2001 terrorist attacks (for example, Belgium, Denmark, France, Germany, and the Netherlands).

Schemes established after September 2001 were generally set up as immediate responses to market failure in terrorism insurance, and were expected to be temporary in nature. Reflecting this, some schemes, such as those in Germany and the United States, include sunset clauses. Similar to the Australian scheme, they exist on a temporary basis with the intention that they only continue to operate while sufficient terrorism insurance cover remains commercially unavailable on reasonable terms. As with the Australian scheme, these two schemes are also subject to periodic review. Both the United States and German governments have extended their respective schemes.

Internationally, many terrorism schemes are public sector schemes, owned by the government. However, some are public-private partnerships run by an administrator operated as a mutual on behalf of insurance companies, but backed by a government guarantee.

Private sector provision of terrorism insurance around the world is limited. In most countries, the private sector does not provide terrorism insurance, even in countries where there is no terrorism insurance scheme. In India and Singapore, limited terrorism reinsurance is provided by industry consortiums.

While the Australian scheme covers property that has predominantly commercial floor space, a number of schemes among other OECD countries go further, covering all commercial property, residential property and their contents. The German, UK and US schemes resemble the Australian scheme most, focussing on cover for commercial property and business interruption.

Similarly, while the Australian scheme excludes cover for nuclear and radiological risks, they are covered by a number of other schemes. The Danish scheme was established specifically to cover nuclear, radiological, chemical and biological risks. The German scheme, on the other hand, excludes nuclear risks, while insurers in the United States have the option to exclude coverage for NBCR risks.

For a detailed description of the operation and ownership structures of foreign terrorism insurance schemes, see Section 5 of the Pottinger Report.

16 Sturdevant, Matthew 31 December 2014, Hartford Courant, www.courant.com/business/connecticut-insurance/hc-terrorism-insurance-act-expires-20141231-story.html,viewed 29 January 2015.

17 Lehrer, Eli, 23 December 2014, The Weekly Standard, www.weeklystandard.com/blogs/market-fine-after-congress-fails-reauthorize-fed-backed-terrorism-risk-insurance_822353.html, viewed 29 January 2015.

ANNEX A: POTTINGER REPORT

ANNEX B: FINITY REPORT