Terrorism Insurance Act

Review 2009

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Glossary of terms

ARPC	Australian Reinsurance Pool Corporation
CAC Act	*Commonwealth Authorities and Companies Act 1997*
CBD	Central Business District
CIPMA	Critical Infrastructure Protection Modelling and Analysis program
CROs	Credit Risk Officers
DTI	Declared Terrorist Incident as defined in the *Terrorism Insurance Act 2003*
GAO	Government Accountability Office, an independent, nonpartisan agency that works for the United States Congress. Often called the 'congressional watchdog,' GAO investigates how the federal government spends taxpayer dollars. The head of GAO is the Comptroller General of the United States
GAREAT	Gestion de l'Assurance et de la Réassurance des risques d'Attentats et Terrorisme, the French terrorism reinsurance scheme.
ISR	Industrial Special Risks insurance
Line of credit	The $1 billion commercial line of credit facility that expired on 30 June 2009. The due repayment of the facility was guaranteed by the Commonwealth as a part of its $10 billion indemnity of the terrorism insurance scheme.
OECD	Organisation for Economic Co-operation and Development
NBC	Nuclear, biological and chemical risks
NBCR	Nuclear, biological, chemical and radiological risks
NIBA	National Insurance Brokers Association
PWG	President's Working Group on Financial Markets, established in 1988 to report to the United States President on private sector solutions and if appropriate, legislative changes, for 'enhancing the integrity, efficiency, orderliness, and competitiveness of the [United States] financial markets and maintaining investor confidence' (Executive Order 12631 of 18 March 1988).

Glossary of Terms (continued)

Retentions	The terrorism risk retained by insurers. Currently, this is the lesser of $10 million and 4 per cent of fire and industrial special risk premium, with a minimum retention of $100,000. The maximum industry retention per incident is $100 million.
Retrocession	The passing of all or part of a reinsurance risk covered by a reinsurer to another reinsurer in return for a premium. The ARPC has placed retrocession coverage for the scheme with a panel of Australian and international reinsurers.
Retrocessionaire	A reinsurer that accepts retrocession risk. The reinsurers that the ARPC has placed retrocession coverage with are referred to in this report as retrocessionaires.
RISe	Reinsurance Information System, the ARPC's client information management system.
Pool	The pool of money available to the ARPC to meet the cost of claims in the event of a declared terrorist incident. The pool is disclosed in the ARPC's financial statements as the 'Reserve for Claims', which consists of total assets less total liabilities, adjusted for asset revaluation.
Premiums	Reinsurance premiums paid by insurers to the ARPC unless otherwise specified.
Reserve for claims	See 'Pool'
Surplus monies	A term defined in the CAC Act as 'the money of the authority that is not immediately required for the purposes of the authority'.
TRIA	*Terrorism Risk Insurance Act 2002*
TRIEA	*Terrorism Risk Insurance Extension Act 2005*
TRIPRA	*Terrorism Risk Insurance Program Reauthorization Act 2007*

EXECUTIVE SUMMARY

AUSTRALIA'S TERRORISM INSURANCE SCHEME

Australia's terrorism insurance scheme was established to minimise the wider economic impacts that flowed from the withdrawal of terrorism insurance in the wake of the terrorist attacks in the United States of America on 11 September 2001.

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

With a large pool of assets uninsured for terrorism risk, the uncertainty facing financiers and investors could have had broader economic impact by delaying the commencement of investment projects and altering portfolio management decisions.

The Australian government was concerned that the lack of terrorism insurance for commercial property or infrastructure would lead to less financing and investment in the Australian property sector, with subsequent wider economic impacts.

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, and that any intervention should be consistent with:

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

- the need to be compatible with global solutions.[1]

Subsequently, Australia's terrorism insurance scheme was established under the *Terrorism Insurance Act 2003* 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 Australian Reinsurance Pool Corporation (ARPC). The scheme started on 1 July 2003.

REVIEW OF THE SCHEME

Need for the Act to continue

The scheme was established as an interim measure and is intended to operate only while terrorism insurance cover is unavailable commercially on reasonable terms. At the time it was established, the Government also considered that uncertainty in the market made it impossible to stipulate the details or timing of its windup.[2] As a result, the Act requires that at least once every three years after the startup time, the Minister must prepare a report that reviews the need for the Act to continue in operation.[3]

2006 review

The first review of the Act was conducted in 2006.[4] It concluded that there was still a need for the Act to continue subject to further review in no more than three years. It found that, while the market for terrorism insurance had recovered somewhat since the scheme was introduced, insufficient terrorism insurance was available commercially on reasonable terms.

The review also identified a need to encourage private sector involvement, to the greatest extent possible, to avoid crowding out the market and allow the government to withdraw once terrorism insurance was commercially available on reasonable terms. It noted that it was important for the ARPC to develop its exposure modelling capability to encourage greater private sector involvement in terrorism cover.[5]

2009 review

The 2009 review considers the need for the Act to continue in the context of the international terrorism insurance market, which until recently was characterised by

1 The Hon Peter Costello MP, Treasurer, 'Terrorism Insurance', media release no. 64, 25 October 2002.
2 Terrorism Insurance Bill 2002, Revised Explanatory Memorandum, paragraph 1.8, p 2.
3 *Terrorism Insurance Act 2003*, section 41.
4 The recommendations of the review were agreed by Government and implemented in full.
5 See Appendix A for the recommendations arising from the 2006 review. The full report may be viewed at http://www.treasury.gov.au.

improvements in the availability and affordability of terrorism insurance, subject to certain limitations. Despite these improvements, there remains insufficient commercial capacity to meet demand for terrorism insurance at affordable rates. While global capacity for reinsurance of terrorism risk has improved for national pooled arrangements, there is insufficient capacity at reasonable prices for individual risks.

Additionally, the favourable market and underwriting conditions that had previously contributed to improved market conditions, deteriorated in the second half of 2008 as insurers and reinsurers responded to a decline in the value of investment portfolios due to the impact of the global financial crisis, and dealt with a series of significant weather-related events.

Although the Australian general insurance industry has remained relatively financially stable despite the global economic environment and difficult underwriting conditions, it is nonetheless part of the international reinsurance market. Internationally, the underlying shortage of affordable reinsurance for terrorism risk is ongoing and the full impact of the global financial crisis on the availability and affordability of reinsurance is as yet unknown.

This review therefore recommends that the Act continue in operation, subject to further review in no more than three years, at which time further examination of the availability of commercial reinsurance on reasonable terms should be undertaken.

Current market conditions are not conducive to phasing out or ceasing Australia's terrorism insurance scheme. This review supports of maintaining, to the greatest extent possible, private sector provision of terrorism insurance, noting that permanent government-subsidised reinsurance would remove any incentive for the private sector to develop alternative arrangements. This is reflected in recommendations relating to premiums and the pool; line of credit; and residential property (high-rise buildings).

See Chapter 2 for a discussion of the need for the Act to continue in operation.

Refinements to the scheme

Subject to the Government's agreement to the need for the Act to continue in operation, this review also recommends refinements to the operation of the scheme as follows:

- **Premiums and the pool** — that the ARPC continue to collect premiums at current rates and investigate the purchase of further retrocession with funds from the pool, and that the relationship between premiums and the pool, and the impact of retrocession on the pool and the scheme more generally, be further considered in the context of the 2012 review.

- **Retentions** — that industry retention levels remain at the levels that took effect on 1 July 2009, noting that the appropriateness of the current levels and structure of retentions should be re-examined in the course of the 2012 review.

- **Line of credit** — that the ARPC not be required to maintain a line of credit facility for the scheme, guaranteed by the Commonwealth, at the current time but should investigate purchasing additional retrocession capacity for the scheme with the funds that would otherwise have been used to pay the maintenance fee for the line of credit. The ARPC should also continue to monitor its overall liquidity position and the need for a line of credit or other liquidity source in light of market retrocession capacity and pricing and any other relevant factors.

- **Residential property (high-rise buildings)** — that the ARPC examine the effects of extending the scheme to mixed-use high-rise buildings that are not predominantly for commercial use, having regard to the need to maintain, to the greatest extent possible, private sector provision of terrorism insurance, and allow the re-emergence of commercial markets for terrorism risk cover. The ARPC should report to the Minister with findings and recommendations by 30 September 2010.

- **Residential property (defence force and student accommodation)** — that property that is wholly for residential use, including defence force and student accommodation involving commercial property financing, continue to be excluded from the scheme.

- **Postcode allocation** — that Treasury, with the assistance of an outside contractor, update the allocation of individual postcodes to particular tiers to ensure that all postcodes are allocated to the correct tier. As part of this process, the ARPC model the impact of any reallocation of postcodes to different tiers and advise the Government of its findings. Subject to the recommendation being accepted, there should be a sufficient transitional period to allow insurers and policyholders to adjust to any reallocation of postcodes.

See Chapter 3 for a discussion of these issues and full recommendations.

ARPC's performance and financial stability of the scheme

The ARPC was established and has certain functions and powers specified under the Act. It is primarily responsible for the administration of Australia's terrorism insurance scheme. It must meet its obligations under the Act and the *Commonwealth Authorities and Companies Act 1997*, and respond to the Australian Government's Statement of Expectations for the ARPC.

As evidence of the ARPC's performance in administering the scheme and building the financial stability of the scheme, this review has considered positive feedback from industry stakeholders, objective measures of the ARPC's performance, the ARPC's achievements in developing its loss estimation capability, its successful retrocession program, and other activities such as awareness raising, financial management, cedant reviews and international engagement.

This review recommends that the ARPC's performance over the 2006 to 2009 period, including in building the financial stability of the scheme through its management of the pool and purchase of retrocession, be noted. It also recommends that the ARPC continue to develop its risk modelling and loss estimation capabilities to support the financial stability of the scheme.

See Chapter 4 for a discussion of the ARPC's performance and the financial stability of the scheme.

INTRODUCTION

OVERVIEW OF THE SCHEME

Operation and coverage

The *Terrorism Insurance Act 2003* establishes a scheme for replacement terrorism insurance coverage for commercial property and associated business interruption and public liability claims. It deems terrorism risk cover into eligible insurance contracts and establishes the ARPC to manage the scheme. Insurance companies are able to reinsure the risk of claims for eligible terrorism losses through the ARPC, in which case premiums are payable to the ARPC.

More specifically, 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'.[1] It makes these clauses ineffective for all classes of insurance included in the scheme, for those risks covered by the policyholder's insurance. This requires insurers to meet eligible claims in accordance with the other terms and conditions of their policies.

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

- loss of, or damage to, eligible property that is owned by the insured;
- business interruption and consequential loss arising from loss of, or damage to, eligible property that is owned or occupied by the insured or an inability to use all or part of such property; or
- liability of the insured that arises out of the insured being the owner or occupier of eligible property.[2]

'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

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1 Sections 6-8.
2 Subsection 7(1).

- property prescribed by regulation.[3] The *Terrorism Insurance Regulations 2003* (the Regulations) prescribe tangible property in, on or under the seabed.[4]

Cover is also available for all Commonwealth and state and territory public authorities. Farms can also obtain cover if they hold insurance against business interruption.

The scheme does not cover residential property or contents of residential property. The Regulations also exclude contracts of insurance for other matters including workers' compensation insurance, marine insurance, aviation insurance, motor vehicle insurance, life insurance, health insurance, private mortgage insurance, medical indemnity insurance and professional indemnity insurance.[5]

Insurers can, but do not have to, reinsure their terrorism risk with the ARPC, the statutory authority established by the Government under the Act to administer the scheme and to provide reinsurance cover for eligible terrorism losses.

The ARPC covers eligible terrorism losses for any declared terrorist incident covered by an eligible insurance contract where the insurer has a reinsurance agreement with the ARPC. 'Eligible terrorism losses' do not include a loss or liability arising from the hazardous properties of nuclear fuel, material or waste.[6] However, they do include loss or liability arising from biological and chemical material incidents.

Funding

The scheme is a hybrid pre- and post-funded model that operates to spread the cost of any claims between policyholders, insurers and the Australian Government through the ARPC as follows:

3 Section 3.
4 Regulation 4.
5 Regulation 5.
6 Section 3.

Layer	Element
Layer 1	Policyholder's liability for some risk through a possible excess or deductible
Layer 2	Retention of some risk by insurers, up to a maximum industry retention per incident of $100 million as of 1 July 2009
Layer 3	ARPC pool, deemed at $300 million[(a)]
Layer 4	Retrocession layer 1: $300 million excess of $300 million
	Retrocession layer 2: $1.6 billion excess of $600 million
	Retrocession layer 3: $400 million excess of $2.2 billion
Layer 5	Australian Government indemnity for up to $10 billion, incepting at $2.6 billion of losses, guaranteed by the Commonwealth
Layer 6	Possible liability for some risk by policyholders through the operation of the reduction percentage or policy limits, for losses excess of $12.6 billion

(a) See Chapter 3 for further information.

Prior to 30 June 2009, the ARPC also had access to a line of credit facility, which sat above the pool and retrocession coverage (as of inception of the retrocession program on 31 December 2008) and below the Commonwealth indemnity ($1 billion of which guarantees the line of credit). The line of credit facility expired on 30 June 2009 and has not been replaced. Whether or not the facility will be replaced is a matter of consideration for this review, the Government and the ARPC. See Chapter 3 for a detailed discussion of the line of credit facility.

Insurers pay premiums to the ARPC for reinsuring their terrorism risk. Premiums payable to the ARPC are a percentage of the underlying premium, that is the premium payable by policyholders to insurers who choose to reinsure through the scheme. Insurers may pass on the cost of reinsurance to their policyholders through their premium. This is a commercial decision for the insurer.

The premiums charged by the ARPC for coverage under the terrorism insurance scheme fall within three broad tiers (A, B and C) which are based on geographic location and defined by postcode, broadly corresponding to risk. Premiums are set by ministerial direction. While the reinsurance rate is not indexed, it reflects any change in the underlying premium and thereby also reflects the risks factored into that premium.

As of 1 July 2009, annual insurer retentions are the lesser of $10 million and 4 per cent of an insurer's gross written premium for fire and industrial special risks (ISR) per year, with a minimum insurer retention of $100,000. The maximum retention by industry per event is $100 million.

If the Commonwealth indemnity is called on following a declared terrorist incident, the Minister may increase the ARPC's premiums to recoup losses, rebuild the pool and repay the Australian Government indemnity. The ministerial power of direction in section 38 of the Act that allows the Minister to set premiums also includes the power to require the ARPC to pay money to the Commonwealth. Any such ministerial direction is a legislative instrument for the purposes of the *Legislative Instruments Act 2003*.

See Chapter 3, which deals with funding of the scheme in greater detail.

Declaring a terrorist incident and paying claims

Under the Act, the Minister must declare a terrorist incident to render the terrorism exclusion clauses in eligible insurance contracts ineffective. The Minister's declaration would be a legislative instrument under the *Legislative Instruments Act 2003*.

Following a declared terrorist incident, the scheme will provide cover, in excess of the maximum insurer and industry retentions, to insurers with a reinsurance agreement with the ARPC that have paid the relevant premiums.

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

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

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

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

OVERVIEW OF THE REPORT

International approaches

Chapter 1 of this report considers the Australian terrorism insurance scheme in the context of schemes that have been developed internationally. Including Australia, approximately 18 countries have established various kinds of cooperative terrorism insurance arrangements and of these, 10 are public-private partnerships with government involvement of varying degrees.

Government and private sector responses to managing terrorism risk are varied and no two schemes are the same. Australia's terrorism insurance scheme has a number of similarities with schemes established in major OECD economies, particularly those established following the events of September 2001, but remains responsive to the particular needs of the Australian financial market. It also exists within a global reinsurance market that continues to be characterised by insufficient capacity at affordable prices for individual risks. Subject to the outcome of this review, the proposed continuation is consistent with the approaches of major OECD economies, where governments have yet to decide that domestic and international insurance and reinsurance markets have recovered sufficiently for the schemes to be phased out or ceased.

Need for the Act

Chapter 2 considers the need for the Act to continue in the context of developments in the domestic and international insurance and reinsurance markets over the 2006 to 2009 period.

Refinements to the scheme

Subject to Government's agreement to the Act continuing for another three years, **Chapter 3** considers refinements to key aspects of the operation of the scheme including:

- **premiums and the pool** — whether reinsurance premiums payable to the ARPC should cease or be reduced once the premium pool reaches $300 million;

- **retentions** — whether current retention levels are sufficient to encourage greater involvement of the commercial insurance market in providing terrorism risk cover;

- **line of credit** — whether the $1 billion line of credit facility previously purchased by the ARPC is still required, given the increased cost of the facility and that a significant pool from which to pay claims now exists;

- **residential property** — whether the scheme should be extended to include high-rise buildings that are predominantly or wholly for residential use, and defence force and student accommodation involving commercial property financing; and

- **postcode allocation** — whether to update the allocation of postcodes to tiers to ensure that all postcodes are allocated to the correct tier.

ARPC's performance and financial stability of the scheme

Chapter 4 considers the ARPC's performance and the financial stability of the scheme in the context of the ARPC's:

- responsibility for the administration of the scheme;
- obligations under the Act and the *Commonwealth Authorities and Companies Act 1997*; and
- responsibility to respond to the Australian Government's Statement of Expectations for the ARPC, which sets out the roles and responsibilities of the ARPC, the relationships of the Board and issues relating to the transparency, accountability and operation of the ARPC.

In addition to its primary role of providing terrorism reinsurance, the ARPC is responsible for advising the relevant Treasury minister of likely costs to the scheme in the event of a declared terrorist incident. As well as considering stakeholders' views of the ARPC's performance and objective measures of that performance, Chapter 4 considers the ARPC's loss estimation capabilities, and the data collection and data sharing activities which assist in the development of those capabilities.

In light of the global finance crisis and recent weather-related events that have contributed to more difficult market conditions for the general insurance industry, Chapter 4 also considers the ARPC's retrocession program and its impact on the financial stability of the scheme.

Appendices

The report concludes with a series of appendices covering:

- recommendations arising from the 2006 review (**Appendix A**);
- the Terms of Reference for the 2009 review (**Appendix B**); and
- the list of stakeholders consulted for the purposes of the 2009 review (**Appendix C**).

CHAPTER 1: INTERNATIONAL APPROACHES

Internationally, government and private sector responses to managing terrorism risk are varied. A relatively small number of schemes predate the events of September 2001, but most were established following those events. Most schemes operate with both government and private sector involvement, and a relatively small number are operated entirely by either government or the private sector.

Including Australia, approximately 18 countries have established various kinds of cooperative terrorism insurance arrangements. Ten of these are public-private partnerships with government involvement of varying degrees, seven are private sector responses and one (Israel) is a government response.

Of the 18 countries that have established various kinds of terrorism insurance schemes, 11 are members of the Organisation for Economic Co-operation and Development (OECD). The remaining 19 OECD countries have not established terrorism insurance schemes, and a number of non-OECD countries have established terrorism insurance schemes of various kinds.

TERRORISM INSURANCE SCHEMES WITH GOVERNMENT INVOLVEMENT

Eleven OECD countries, including Australia, have terrorism insurance schemes in place. Eight of the 11 schemes have been established with varying degrees of government involvement in partnership with the private sector (including the Spanish scheme which is government-controlled). Two of the eight schemes were established prior to the events of September 2001 (Spain and United Kingdom) and six were established following those events. Namibia and South Africa, which are non-OECD countries, also have schemes that have been established under government and private sector partnerships. Both schemes predate the events of September 2001.

OECD countries

Belgium

As of 1 May 2008, insurance companies were required by law to provide mandatory insurance cover against terrorism risks.[1] The Terrorism Reinsurance and Insurance Pool (TRIP) was created on 1 February 2008 to provide reinsurance coverage.[2]

The maximum insured amount per calendar year is €1 billion (indexed from 2005), which is split among the three layers of the pool. The first layer up to €300 million is provided by participating insurers. The second layer of €400 million is provided by reinsurers, and the final layer of €300 million is provided by the Belgian Government.[3] Layers move up each year with inflation.

Although participation in the arrangement is not compulsory, 90 per cent of insurers are members of the scheme.[4]

The new terrorism scheme extends the mandatory requirement to provide coverage to accident, health, and life insurance exposures.[5] Nuclear, biological and chemical (NBC) risks are covered for policies where terrorism coverage is compulsory and where it is included in specific policies, although 'nuclear bombs' can be excluded.[6]

France

The Gestion de l'Assurance et de la Réassurance des risques d'Attentats et Terrorisme (GAREAT) is a reinsurance pool that offers protection to direct insurers if they cede the terrorism risk forming part of all qualifying policies within their portfolio and the corresponding premium. The premium is calculated as a percentage of the total premium collected by insurers on the insurance policies they provide.[7]

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1 Marsh, 'Belgian Law Requires Mandatory Terrorism Insurance Coverage', December 2008, viewed 10 June 2009, p 1. http://global.marsh.com/documents/Internationalbriefings/MandatoryTerrorismInsuranceLawBelgium12-18-08.pdf.

2 Guy Carpenter, 'Global Terror Update 2009', 2009, viewed 15 July 2009, p 7, http://gcportal.guycarp.com/portal/extranet/popup/insights/reportsPDF/2009/Global_terror_2009.pdf?vid=1.

3 Marsh, 'Belgian Law Requires Mandatory Terrorism Insurance Coverage', op cit, p 2.

4 Guy Carpenter, 'Global Terror Update 2009', op cit, p 7.

5 Alexis Fontein, 'Belgium: New Terrorism Insurance Scheme', Lloyd's, 13 September 2007, viewed 8 May 2009, http://www.lloyds.com/Lloyds_Worldwide/International_compliance_news/Belgium_New_Terrorism_+Insurance+Scheme.htm.

6 Guy Carpenter, 'Global Terror Update 2009', op cit, p 8.

7 Organisation for Economic Co-operation and Development, *Policy Issues in Insurance No.9: Terrorism Risk Insurance in OECD Countries*, OECD Publishing, Paris, 2005, pp 94-99, 243-247.

The GAREAT is composed of two sections. The first was established in 2002 to cover large and medium-sized risks (sums insured at and above €6 million) and the second section was established in 2005 to cover small risks (sums insured under €6 million).

GAREAT protection for large and medium-sized risks previously provided reinsurance up to a limit of €2 billion, after which the French Government acted as lender of last resort by offering unlimited protection. This system was restructured on 1 January 2007[8], with coverage now provided up to a limit of €2.2 billion.[9] Coverage is mandatory for insurers who are members of the French Federation of Insurance Companies and of the GEMA (the group of mutual insurance companies operating without intermediary). However, coverage for small risks is optional. The structure of coverage for small risks is similar to that for medium and large risks, where coverage is provided up to a limit of €2.6 billion, after which the French Government provides an unlimited state guarantee.[10]

As of 2007, GAREAT no longer accepts risks where there is no fire guarantee. Additionally, private reinsurers willing to participate in the GAREAT have been asked to provide reinsurance cover for any acts of terrorism, as described by the French Code of Insurance and French Criminal Code. This means that all acts of terrorism are covered by GAREAT, including those committed through the use of nuclear weapons.[11]

Germany

Germany established Extremus Versicherungs-AG in September 2002 following the events of 11 September 2001.[12] Coverage of terrorism risk is optional and membership of Extremus is voluntary. Extremus provides cover for terrorism risks in return for premiums, and will only take on risk where the sum insured is over €25 million.[13] Coverage is not extended to war, warlike events, looting, acts by authorities and NBC attacks.[14]

The scheme provides €10 billion in cover each year. The first €2 billion of capacity is placed with approximately 50 domestic and foreign insurers and reinsurers. An

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8 Guy Carpenter, 'Global Terror Insurance Market: The World Continues on High Alert', June 2007, viewed 11 August 2009, p 10. http://gcportal.guycarp.com/portal/extranet/popup/pdf_2007/GCPub/Terror%20Report%202007.pdf.
9 Guy Carpenter, 'Global Terror Update 2009', op cit, p 11.
10 Information from GAREAT respondent, email received 16 June 2009.
11 Lloyd's, 'France: GAREAT in 2007', 24 November 2008, viewed 11 August 2009, http://www.lloyds.com/Lloyds_Worldwide/International_compliance_news/France_GAREAT_in_2007.htm.
12 Guy Carpenter, 'Global Terror Update 2009', op cit, p 15.
13 OECD, *Policy Issues in Insurance*, pp 94-99, 255-260.
14 ibid, p 16.

€8 billion government guarantee covers losses greater than €2 billion, up to a limit of €10 billion in losses.[15] The German Finance Minister extended the government guarantee in November 2007 for another two years.[16]

A new tariff was introduced for the 2008 underwriting year, which allows Extremus to specifically price risks according to their location and vulnerability.[17]

Netherlands[18]

The Nederlandse Hervezekeringsmaatschappij voor Terrorismeschaden (NHT; Netherlands Reinsurance Company for Terrorism Losses), which was established in 2002, reinsures terrorism risks in the Netherlands by attaching the NHT clauses to underlying insurance policies. The pooling arrangement limits the NHT's total exposure to €1 billion per event per year for all lines.

Participating insurers, once having decided to become members of the NHT, are deemed to cede all their terrorism exposure to the pool.

NHT participants are charged for the reinsurance premium. Reinsurance premiums reflect the market share of each NHT member.

As of 1 January 2006, public healthcare business fell under the scope of the NHT, due to the introduction of a basic healthcare coverage for all Dutch citizens.

Spain

In Spain, terrorism is one of a number of 'extraordinary risks'. Cover for extraordinary risks is available from the Consorcio de Compensacion de Seguros (CCS). Initially established in 1941, it is a government-controlled fund that provides compensation for losses that are not covered in the private insurance market.[19]

CCS acts as a warrant fund when a private insurer can no longer fulfil its obligations (following insolvency, for example). An unlimited state warranty supports CCS if losses are above its own capacity for payment.[20]

The CCS charges a premium for providing cover. The applicable rate depends on the insurance policy.

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15 OECD, *Policy Issues in Insurance*, op cit, p 15.
16 ibid, p 16.
17 ibid, p 16.
18 ibid, pp 17-18.
19 ibid, p 19.
20 ibid, pp 94-99, 253-255.

There are no insurer retentions under the scheme.[21]

United Kingdom

Pool Re is a mutual reinsurer in the United Kingdom, authorised to cover losses resulting from an act of terrorism, as defined by the legislation.[22]

Insurers are required to provide terrorism cover under certain insurance policies, where an insured requests such cover. An insurer then has the option to reinsure this risk with Pool Re.[23]

Pool Re covers commercial property, business interruption and related classes, including residential property in commercial ownership.[24] Terrorism cover was extended to an 'all risks' basis in 2003, and now includes nuclear, biological, chemical and radiological (NBCR) attacks. The only exclusions applying to terrorism cover are war and related risks, and damage caused to computer systems by virus, hacking and similar actions.[25]

Insurers pay a premium to Pool Re for coverage under the scheme. The size of the retention an insurer must pay before Pool Re reimburses the cost of a claim varies between insurers depending on the size of their terrorism insurance portfolio. Reinsurance is provided at stipulated rates.[26]

In 2003, industry-wide retentions were set at £30 million per event and £60 million per year. These retentions were increased to the current levels of £100 million and £200 million respectively in 2006.[27]

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21 OECD, *Policy Issues in Insurance*, op cit, pp 94-99, 253-255.
22 ibid, pp 94-99, 255-260.
23 Guy Carpenter, 'Global Terror Update 2009', op cit, p 22.
24 OECD, *Policy Issues in Insurance*, op cit, pp 94-99, 255-260.
25 Pool Re, 'Cover Provided', 2008, viewed 11 August 2009, http://www.poolre.co.uk/.
26 OECD, *Policy Issues in Insurance*, op cit, pp 94-99, 255-260.
27 ibid, pp 94-99, 255-260.

After the retentions have been met, losses arising from a terrorist incident would be covered by the funds in the pool.[28] The UK government then acts as a lender of last resort by providing unlimited cover should the assets accumulated by the program become exhausted.[29] Pool Re pays a premium to the government for this cover and would be required to repay any funds drawn down in this way from its future income.[30]

United States

The United States' Terrorism Risk Insurance Act of 2002 (TRIA) requires insurers to make cover available for losses arising from an act of terrorism, in certain lines of commercial property and casualty insurance policies. TRIA was extended to 31 December 2014 after the President signed into law the Terrorism Risk Insurance Program Reauthorization Act of 2007 (TRIPRA).[31]

Insurers are required to offer terrorism cover to all commercial insureds (although insurers' standard exemptions may exclude coverage for terrorist attacks involving NBCR materials[32]). However, it is optional for the insured to purchase cover.[33]

Liability for terrorism cover remains with private insurers unless the event is officially certified as an 'act of terrorism'. This will occur if the event meets a number of requirements specified in TRIA.[34] A previous condition for certification was that only foreign acts of terrorism were covered. However, TRIPRA provides for domestic acts of terrorism to now also be covered.[35]

Where an incident is certified, the United States government will cover losses above insurer retention levels, set as a percentage of the insurer's direct earned premium written the previous year. In 2003, insurer retentions were set at 7 per cent of the insurer's direct earned premium over the previous year. The government steadily increased this retention level to 20 per cent in 2007.[36] This level has remained unchanged into 2009.[37]

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28 OECD, *Policy Issues in Insurance*, op cit, pp 94-99, 255-260.
29 Guy Carpenter, 'Global Terror Update 2009', op cit, p 21.
30 Pool Re, 'Cover Provided', op cit.
31 United States Department of the Treasury, *Federal Register*, vol 73, no. 19, 28 January 2008, p 5,265, http://www.treas.gov/offices/domestic-finance/financial-institution/terrorism-insurance/pdf/interim_guidance_01282008.pdf.
32 Guy Carpenter, 'Global Terror Update 2009', op cit, p 4.
33 OECD, *Policy Issues in Insurance*, op cit, pp 94-99, 260-264.
34 ibid, pp 94-99, 260-264.
35 Department of the Treasury, *Federal Register*, pp 5, 265.
36 Guy Carpenter, 'Global Terror Insurance Market', op cit, p 4.
37 Guy Carpenter, 'Global Terror Update 2009', op cit, p 3.

Insurers are liable for the incident up to this annual deductible, after which the United States government is responsible for paying 85 per cent of the insurer's losses. This level was reduced in 2007 from 90 per cent.[38]

There is an annual industry aggregate cap of $100 billion[39], which has been steadily increased from $10 billion in 2003.

See Chapter 2, which deals with the need for the Act to continue in the context of international market developments over the 2006 to 2009 period, for further detail on the United States' arrangements.

Non-OECD countries

Israel[40]

Israel has two government schemes, providing cover for life and health, and property-casualty risks. Primary insurance policies only cover risks for damages not covered by the government schemes.

The Victims of Hostile Action (Pensions) Law was established in 1970, and it provides compensation for bodily injuries suffered in terrorist attacks, as well as compensation to family members of deceased victims. According to the law, victims of terror attacks and their families (regardless of when they receive Israeli citizenship) are entitled to financial compensation from the State of Israel.

The Property Tax and Compensation Fund Law was established in 1961, and it provides compensation for property damage caused by terrorism. The government compensates at market values for any loss of property resulting from a hostile act. Unlimited cover is provided for direct damage to property.

Namibia[41]

Primary insurance for damage from terrorist acts is provided by the National Special Risks Association (NASRIA). NASRIA was established in October 1987 in response to the cancellation of reinsurance facilities previously available to the conventional insurance market for acts of terrorism and politically motivated acts. The Namibian government acts as insurer of last resort. To avoid gaps in cover, NASRIA includes riot, strike and labour disturbances, which were previously excluded from conventional policies.

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38 Guy Carpenter, 'Global Terror Insurance Market', op cit, p 4.
39 Guy Carpenter, 'Global Terror Update 2009', op cit, p 3.
40 ibid, p 29.
41 ibid, p 30.

South Africa[42]

The South African Insurance Association created the South African Special Risks Insurance Association (SASRIA) in 1979 in response to a lack of available conventional insurance market cover for politically motivated acts caused by an escalation of politically motivated violence and damage in South Africa during the 1970s (particularly the Soweto riots of 1976).

The primary objective of SASRIA is to provide insurance cover to protect assets against certain defined events, particularly politically motivated acts including terrorism and political riot. Coverage provided under SASRIA was extended in 1987 to include all riot, strike and public disorder, regardless of the motivations.[43]

In order to eliminate gaps in cover, insureds must be covered for every insurable risk. This is so that in the event of a claim, either the SASRIA policy or the underlying policy can respond.

The South African Government acts as reinsurer of last resort.

COUNTRIES WITH PRIVATE TERRORISM INSURANCE SCHEMES

Of the 11 OECD countries with terrorism insurance schemes in place, three have been established without government involvement. Bahrain, India and Taiwan, which are non-OECD countries, also have schemes that have been established without government involvement. Hong Kong, a self-governing territory of China, also has a private scheme.

OECD countries

Austria

In Austria, the Verband der Versicherungsunternehmen Osterreichs (the Austrian Insurance Association) created the Osterreichischer Versicherungspool zur Deckung von Terrorrisiken (the Austrian Terrorpool) on 1 October 2002 as a purely private co-reinsurance pool. It provides protection against property damage and business interruption with a sum insured up to €5 million for each location, policy holder and calendar year. Risks with a total sum insured exceeding €5 million are covered on a

42 South African Special Risks Insurance Association, 'An Extraordinary Company', 2007, viewed 11 August 2009, http://www.sasria.co.za/.

43 Guy Carpenter, 'Global Terror Update 2009', op cit, p 30.

facultative basis. The scheme places reinsurance of €150 million in annual aggregate in excess of a €50 million retention in the international reinsurance market.[44]

While the scheme is voluntary, 99 per cent of Austrian Insurance Association members belong to the pool.[45]

Finland[46]

All but two Finnish insurance companies participate in the Finnish Terrorism Pool. The pool is intended as a measure of last resort in the event of a major terrorism loss in Finland, in which case recovery would be made under the pool only after all traditional reinsurance programs had been exhausted. For personal lines, there are no terrorism exclusions. Exclusions are imposed on industrial and commercial lines, but with a €3 million per policy write-back. Reinsurance generally follows the original conditions, but excludes NBC terrorism.

Switzerland[47]

In early 2002 the Schweizer Sachversicherungs-Verband (SVV — Swiss Association of Property Insurers) established a committee to study domestic terrorism insurance issues, as private Swiss insurers had started to exclude terrorism cover for property risks. This resulted in the creation of a terrorism facility for all private property insurers licensed to operate in Switzerland.

Since September 2003, insurers can cede all property risks for buildings, contents, or business interruption with a sum insured between CHF10 million and CHF100 million for treaty cover (and above CHF100 million for facultative cover) to the terrorism reinsurance facility. All primary property insurance policies incepting on or after 1 September 2003 with a sum insured in excess of CHF10 million exclude terrorism risks.

Non-OECD countries

Bahrain[48]

The Arab War Risks Insurance Syndicate (AWRIS) was established in 1980 by a number of Arab insurance and reinsurance companies operating in the Arabian Gulf

44 OECD, *Policy Issues in Insurance*, op cit, pp 94-99, 242-243.
45 Guy Carpenter, 'Global Terror Update 2009', op cit, p 6.
46 ibid, p 9.
47 ibid, p 20.
48 Arab War Risks Insurance Syndicate, 'The Syndicate', 2005, viewed 11 August 2009, http://www.awris.com/home.html.

Area. The primary emphasis was to protect the interests of local insurance markets and to provide war cover during the Iran-Iraq War, with an emphasis on defending the insurance companies situated in the Middle East.

AWRIS is based in Bahrain, and provides special risks insurance facilities to its 170 member companies from 19 Arab countries. The member companies share the retention with quota share and aggregate excess of loss reinsurance placed in London.[49]

Hong Kong

In Hong Kong, the Motor Insurance Bureau (MIB) has established the Hong Kong Motor Terrorist Pool, which is a limited facility of up to HKD200 million (US$26 million).[50] It provides coverage for the claims of innocent third parties in the event of bodily injury caused by a terrorist act through the use of a motor vehicle on the road in Hong Kong. The pool is funded out of the MIB First Fund. In the event that this is exhausted, the MIB will impose additional levies on motorists.[51]

India

Following the events of 11 September 2001, international reinsurers in India began to withdraw cover for terrorism and sabotage risks. This led the Indian general insurance industry to combine its resources to establish a terrorism risk insurance pool. The pool was established in 2002 with an initial sum of RS2 billion. The pool now has an approximate value of RS12 billion and is managed by the General Insurance Corporation of India on behalf of all the non-life insurance companies.[52]

Terrorism cover through the pool is offered as a buy-back. There is a separate rate for terrorism cover, depending on the type of risk and the sum insured, which is approximately 0.03 percent to 0.05 percent of total sums insured. Aggregate losses to any one location for all Indian insurers are limited to RS5 billion (US$102 million), and any further loss involves prorating all recoveries. Excess of loss retrocessional coverage is purchased on the international market.[53]

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49 Guy Carpenter, 'Global Terror Update 2009', op cit, p 29.

50 ibid, p 24.

51 Julian James, 'Market Bulletin: Hong Kong Motor Terrorism Pool', Lloyd's, 6 September 2002, viewed 11 August 2009, http://www.lloyds.com/NR/rdonlyres/3CF07EA6-F404-4595-8C8A-52DAC3027153/0/Y2863.pdf.

52 Rediff Business, 'All about terror insurance', 2008, viewed 11 August 2009, http://health.rediff.com/money/2009/mar/26perfin-all-about-terror-insurance.htm.

53 Guy Carpenter, 'Global Terror Update 2009', op cit, p 25.

Taiwan[54]

In 2004 an insurance pool was created to share terrorism risk for personal accident business among private insurance companies and the Central Reinsurance Corporation in Taiwan. The pool, which is administered by the Non-Life Insurance Association in Taiwan, provides terrorism coverage for personal accident business up to a maximum insured amount of NTD2 million per person. The pool has a cap of NTD1 billion. If losses exceed this amount, claims are paid on a pro rata basis.

Countries without terrorism insurance schemes

According to Guy Carpenter's *Global Terror Update 2009*, there are nine OECD countries that have not established terrorism insurance schemes of any kind in either the public or private sectors: Canada, Denmark, Italy, Norway, Portugal, Sweden, Japan, Korea and Mexico.

A further eight countries which are not OECD members, were identified in the report as not having established terrorism insurance schemes: China, Malaysia, the Philippines, Argentina, Brazil, Chile, Colombia and Peru.

How the Australian scheme compares

In August 2007, the Credit Risk Officers (CROs) of major reinsurance companies Allianz, Chubb, Munich Re and Zurich released an Emerging Risks Initiative Position Paper on terrorism insurance. The CROs observed that there is no 'one-size-fits-all' solution to ensuring an adequate supply of affordable insurance for terrorism risks, but saw permanent public-private terrorism insurance partnerships between insureds, insurers, reinsurers, capital markets and governments, as essential to an effective solution.[55]

In 2009, 18 countries have terrorism insurance schemes of various kinds and 10 of these are public-private partnerships. Of the 10, four of the schemes (Spain, the United Kingdom, Namibia and South Africa) predate the events of September 2001 and the remaining six were established following those events.

The schemes which predate the events of September 2001 reflect the political history of their respective countries. For example: the Spanish scheme was established following the Spanish Civil War; the United Kingdom scheme was established in response to the

54 Guy Carpenter, 'Global Terror Update 2009', op cit, p 26.
55 CRO Forum, 'CRObriefing: Emerging Risks Initiative: Position Paper — Terrorism', CRO Forum, August 2007, pp 7-11, http://www.swissre.com/resources/a3ce0b0047a5b319a2e4f642196b29f1-Terrorism%20Position%20Paper_Nov07.pdf.

political unrest in Northern Ireland; the Namibian scheme was established following a period of political unrest which preceded Namibia's full independence from South Africa in 1990; and the South African scheme was established following the political unrest of the 1970s.

The global scale of the events of September 2001 led to the establishment of schemes in major OECD economies including the United States, France and Germany, and the broadening of existing schemes such as those in Spain and the United Kingdom. However, consistent with the CROs' observation that there is no 'one-size-fits-all' solution, all schemes reflect the particular needs of individual countries and no two schemes are the same.

The key features of the Australian scheme are that: it is a public-private partnership; it is a temporary measure; terrorism exclusion clauses are overridden in eligible insurance contracts; insurer participation via reinsurance with the government reinsurer is voluntary; funding for the scheme consists of a pool of funds accumulated from insurer premiums and investment revenue, reinsurance and a government indemnity; insurer retentions and premiums are set by government; it only covers commercial property and associated business interruption and public liability risks; and it covers biological and chemical risks but excludes loss or liability arising from the hazardous properties of nuclear fuel, nuclear material or nuclear waste.

In OECD countries with terrorism insurance schemes established as public-private partnerships (Belgium, France, Germany, Netherlands, Spain, the United Kingdom and the United States), there are some observable differences, but many of the key features of the schemes are similar.

Like the Australian scheme, the United States and German schemes exist on a temporary basis as they are only intended to operate whilst sufficient terrorism insurance cover is commercially unavailable on reasonable terms. Unlike the United States and German schemes, the Australian scheme has no sunset clause but is subject to review every three years to determine whether there is a need for the Act to continue. Both the United States and German governments have extended their respective schemes.

The United States and Belgian governments ensure that terrorism insurance must be offered by insurers. Although TRIPRA requires American insurers to make cover available for losses arising from acts of terrorism, insureds have the option to accept or decline this cover. As of 1 May 2008, Belgian law requires insurance companies to provide mandatory insurance coverage against terrorism risks.

Participation in terror insurance schemes is voluntary in Belgium, France, Germany, the Netherlands and the United Kingdom. Voluntary participation provides insurers with the option to manage risks themselves (that is, self-insure or reinsure privately), without the assistance of a funded pool or government indemnity. However, non-participating insurers bear the risk of not being able to obtain reinsurance privately (and if so, at a higher cost) and potentially not having their liability capped.

The Belgian, French and United Kingdom schemes provide some combination of a pool, reinsurance and government indemnity. Through the layers, these schemes distribute the cost of terrorism cover between policyholders, insurers and the government (and thus to taxpayers), to achieve a balanced and proportionate approach.

The Australian, French and United Kingdom schemes create a reinsurance pool into which insurance premiums are paid and from which claims are paid. Governments of these countries act as insurers of last resort. This mutualises the risk and moderates the risks retained by insurance firms. The United States' TRIA scheme does not create a pre-funded pool. The scheme requires the insurers to generate their own mechanisms for risk sharing. This has the potential for positive outcomes, where it may facilitate private markets to develop efficient mechanisms for risk sharing. However, the scheme also has the potential for negative consequences if private markets cannot develop risk-sharing structures for terrorism risk. The United States has already found it necessary to extend the operation of TRIA to 2014.

Further similarities can be seen where the French, German, Dutch, United Kingdom and United States governments set insurer retentions and/or premiums. Since the 2006 review, insurer retention levels have increased in France, Australia and the United States. The United States Government now also covers a lower percentage of insurers' losses after retention levels have been met. These measures support a policy intention to encourage a greater level of private sector coverage, reduce government involvement, and avoid government 'crowding out' incentives for private sector competition.

The Belgian, United States and United Kingdom schemes cover commercial property and associated business interruption and public liability risks. The United Kingdom and Australian schemes exclude residential property from coverage, including in commercial ownership.

The Belgian scheme covers NBC risks, but allows for the exclusion of nuclear bombs. Its coverage has also been extended to public health care. The German scheme provides cover against property damage and business interruption, however, no such coverage is provided against NBC risks. The United Kingdom scheme provides coverage against all NBCR attacks. This is similar to the French scheme which covers all acts of terrorism. Insurers in the United States have the option to exclude coverage for NBCR risks.

In conclusion, Australia's terrorism insurance scheme has a number of similarities with schemes established in major OECD economies, particularly those established following the events of September 2001. Like all similar schemes, it responds to the withdrawal of terrorism insurance following those events and exists in a global terrorism reinsurance market that continues to be characterised by insufficient capacity at affordable prices for individual (non-pooled) risks. It has also been structured to meet the particular needs of the domestic financial market so while its combination of policy settings is unique, individual elements are not. Importantly, while the Australian scheme is a temporary measure, it continued to operate following the 2006 review and, subject to the Government's response to the recommendations of this review, will continue to operate until 2012 at which time the need for the Act will be reviewed again. This approach is consistent with that of major OECD economies. That is, where schemes exist on a temporary basis, governments have yet to decide that domestic and international insurance and reinsurance markets have recovered sufficiently for the schemes to be phased out or ceased. These issues are discussed in greater detail in the next chapter, which deals with the need for the Act to continue in the context of international market developments over the 2006 to 2009 period.

CHAPTER 2: NEED FOR THE TERRORISM INSURANCE ACT

Issue

Whether there is a need for the *Terrorism Insurance Act 2003* to continue in operation.

Background

Australia's terrorism insurance scheme was established on 1 July 2003 in response to the withdrawal of commercially available terrorism insurance cover, particularly after the events of 11 September 2001. As a result of significant changes in the terrorism insurance market, there was a large pool of assets uninsured for terrorism risk. In the United States in particular, the withdrawal of affordable terrorism insurance resulted in commercial properties operating without terrorism cover and commercial property developments being delayed or cancelled, with consequent job losses.[1]

Commercial property also plays an important role in the Australian economy in terms of business, employment and investment opportunities. The uncertainty for financiers and investors created by the withdrawal of commercially available terrorism insurance had the potential to delay the commencement of commercial property investment projects and to alter portfolio management decisions, with adverse consequences for the ongoing operation of those assets, as well as for the broader economy.

To protect the economy from the effects of the withdrawal of terrorism insurance, the Australian government established the scheme for commercial property and associated business interruption losses and public liability claims. The scheme is an interim measure, intended to operate only while terrorism insurance cover is unavailable commercially on reasonable terms.

At the time the scheme was established, the government also considered that uncertainty in the market made it impossible to stipulate the details or timing of its windup.[2] As a result, section 41 of the Act requires that at least once every three years after the startup time, the Minister must prepare a report that reviews the need for the Act to continue in operation.

1 op cit, CRO Forum, 'CRObriefing', August 2007, p 6.

2 Terrorism Insurance Bill 2002, Revised Explanatory Memorandum, paragraph 1.8, p 2.

In accordance with section 41 of the Act, the Terms of Reference for this review require consideration of the need for the Act to continue in operation.

Discussion

The 2006 review examined the Australian terrorism insurance market in the context of the global terrorism insurance market and its characteristics before and after the 11 September 2001 terrorist attacks.

Before 11 September 2001, terrorism insurance was included implicitly and virtually free of charge in general property all-risks contracts. Higher cost standalone terrorism insurance was available to fill market gaps left by all-risks contracts.

The 11 September 2001 attacks resulted in unprecedented losses, an increase in the risk associated with high-rise commercial property and greater uncertainty about the ability of insurers to assess and spread risk globally. They also demonstrated the combined negative effects of:

- a simultaneous exposure of multiple insurance lines from one event (individual life, group life, aviation, property, business interruption, worker's compensation and accidental death)[3]; and
- a major terrorist incident on capital markets causing unprecedented underwriting pressure to coincide with a downturn in investments, as well as worsening credit risk resulting in an unwillingness of reinsurers, who were liable for a large proportion of the claims, to renew coverage.[4]

The immediate effect of the 11 September 2001 attacks was the exclusion of terrorism cover in all-risks policies and increased demand for standalone terrorism cover. Premiums rose sharply and contracts were more restrictive as insurers selected their risks more carefully and required policy holders to meet stringent security requirements. The overall effect was a shortage of affordable terrorism insurance.

While the catastrophe underwriting market grew substantially in the months following September 2001, many insurers concluded that they could not sustain large terrorism losses. As a result, standalone cover remained expensive, restrictive and limited in its availability. Financial markets showed little appetite for terrorism risks and there was no expectation that market capacity would increase substantially in the short term.[5]

In countries with a history of political unrest, such as the United Kingdom and Spain, permanent government schemes had been established to provide reinsurance to

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3 The Treasury, *Terrorism Insurance Act Review: 2006,* Canberra, June 2006, pp 29-30.
4 op cit, CRO Forum, 'CRObriefing', p 7.
5 op cit, The Treasury, *Terrorism Insurance Act Review: 2006*, pp 5-6, 27-30.

support the provision of terrorism insurance, although both schemes were broadened following the September 2001 attacks.[6] Following September 2001, other countries including the United States and Australia, implemented temporary schemes to address the economic consequences of a failure in the terrorism insurance market. In other countries such as Austria, India and Taiwan, private schemes were established that do not involve government support.[7] See Chapter 3, International Approaches, for further information.

International market

Overview

Between 2003 and 2006, the international terrorism insurance market was characterised by improvements in the availability and affordability of terrorism insurance: insurance and reinsurance capacity increased; the financial stability of insurers improved; insurer retentions increased; premiums fell or stabilised at competitive rates; and participation rates increased. The development of government schemes to address the shortfall in commercially available reinsurance at affordable rates was probably the most significant contributing factor to these developments.

The same trends were maintained from 2006 to 2008. However, despite significant improvements in risk management and loss estimation modelling, insurers consistently expressed the view that there was insufficient commercial capacity to meet demand for terrorism insurance at affordable rates, particularly in high-risk locations, and that loss events beyond a certain scale surpassed the risk capacity of the industry. Contributing to this was the ongoing shortfall in reinsurance capacity for individual terrorism risks, even though global capacity for reinsurance of terrorism risk had improved for national pooled arrangements. In light of these market conditions, insurers considered that government schemes remained as relevant and necessary in 2008 as they were at the time of their establishment.

Additionally, the terrorism insurance market hardened during 2008 and into 2009 as insurers and reinsurers responded to a decline in the value of investment portfolios due to the impact of the global financial crisis.

The following discussion focuses on the US as the largest terrorism insurance market and one that has attracted industry analysis and commentary over recent years. However, industry views that are more internationally representative indicate that the trends and issues faced by the terrorism insurance and reinsurance markets are more widely shared in the context of global markets.

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6 op cit, Guy Carpenter, 'Global Terror Update 2009', pp 19-21.

7 President's Working Group on Financial Markets, *Terrorism Risk Insurance: Report of the President's Working Group on Financial Markets*, September 2006, p 13. http://www.treas.gov/offices/domestic-finance/financial-institution/terrorism-insurance/pdf/report.pdf.

Detail

In 2006, the US President's Working Group (PWG) on Financial Markets was required to conduct a study of the long-term availability and affordability of terrorism insurance following the passage of the Terrorism Risk Insurance Extension Act 2005 (TRIEA) which extended the Terrorism Risk Insurance Act 2002 (TRIA) from December 2005 to December 2007. The PWG found that the availability and affordability of terrorism insurance had improved since 2001. They also identified better risk management and measurement, improved modelling capabilities, greater reinsurance capacity and the improved financial health of insurers as conducive to encouraging additional capacity in the long term.[8]

The PWG identified the increased availability of reinsurance capacity as contributing to the 're-emergence of the insurance industry', but noted that the 'presence of subsidised Federal reinsurance through TRIA appears to negatively affect the emergence of private reinsurance capacity because it dilutes demand for private sector reinsurance'. Lloyds of London noted that, while it is possible that the withdrawal of TRIA after 2007 would encourage the development of some limited private market solutions, 'significant growth to the point at which reinsurance is generally available at prices that insurers are prepared to pay appears questionable'.[9]

The PWG concluded that the uncertainty associated with predicting the frequency of terrorist attacks, along with an apparent unwillingness of some policyholders to purchase terrorism insurance, made any evaluation of the potential degree of long-term development of the terrorism insurance market 'somewhat difficult'.[10]

In October 2006, Marsh commented on the PWG report noting that, while improved modelling and risk management had allowed insurers to better identify exposures and accumulations, this had resulted in a reduction in capacity, rather than an increase. They considered this to be especially true for risks in urban areas, perceived target risks such as utilities, and locations with large concentrations of employees.[11]

Marsh noted that the estimated $6 billion to $8 billion[12] of available capacity in the reinsurance market for terrorism property risks was inadequate to fill the gap should TRIA be allowed to expire. Its view was that 'it would be prudent to consider a period

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8 op cit, President's Working Group on Financial Markets, *Terrorism Risk Insurance*, pp 23, 31, 44-45 and 79-80.

9 ibid, pp 30-31.

10 ibid, p 80.

11 Marsh, 'Marketwatch: Terrorism Insurance 2006 President's Working Group Report to Congress', October 2006, p 3.

12 The Reinsurance Association of America, Swiss Re and Aon also estimated reinsurance capacity of $6 billion to $8 billion 'at current market conditions' for terrorism insurance. Source: President's Working Group on Financial Markets, 'Terrorism Risk Insurance', p 26.

of at least 10 or more years until the reinsurance market has sufficient capacity to respond to a catastrophic terrorism loss'.[13]

Marsh commented that the premise on which TRIA was enacted, that is protection of the broader economy from the effects of the withdrawal of terrorism insurance, remained valid. Without TRIA, its view was that capacity would not rise to meet demand, but that insurers would supply their net terrorism capacity, resulting in reduced availability of terrorism insurance. Marsh concluded that 'use of the commercial insurance marketplace to adjust losses, distribute funds, and collect a recoupment is one of the most efficient ways for the federal government and business to work together. It should be an important consideration in the development of a future plan'.[14]

In its 2006 analysis of the US market, Marsh described it as 'changing and uncertain'. It observed that terrorism insurance take-up rates increased to record levels (nearly 60 per cent of businesses surveyed). This was despite increased premium rates due to increased property prices and a hardening of the property insurance market, compared to 2005 when terrorism insurance rates generally decreased. Increased take-up rates also occurred despite TRIA being due to expire on 31 December 2007. Although this caused some uncertainty, Marsh's view was that the market was generally optimistic that TRIA would be extended again[15] as fewer insurers were insisting on sunset clauses that would terminate terrorism cover if it was not extended.[16]

Marsh also described terrorism insurance and associated risk management strategies as 'dynamic and complex issues, with many interdependent factors contributing to managing the risk'. It cited foreign relations, the effectiveness of homeland defence and the ambiguous nature of terrorism risk as factors that make it difficult for insurers to effectively price and reserve capacity for potential exposure to catastrophic terrorism losses.[17]

In August 2007, the Credit Risk Officers (CROs) of major reinsurance companies Allianz, Chubb, Munich Re and Zurich released an *Emerging Risks Initiative Position Paper* on terrorism insurance. Like Marsh, the CROs observed that, despite comprehensive data pooling and the development of risk management tools, a number of factors combine to limit the amount of terrorism insurance on offer. They noted the unpredictability of terrorist attacks, combined with insurers needing to sell assets (to

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13 op cit, Marsh, 'Marketwatch: President's Working Group Report to Congress', Marsh, p 3.

14 ibid, pp 4-6.

15 On 18 December 2007, Congress approved the extension of TRIEA until 31 December 2014. The Terrorism Risk Insurance Program Reauthorization Act 2007 was signed by President George W Bush on 26 December 2007.

16 Marsh, 'Marketwatch: Terrorism Insurance — 2006 Market Conditions and Analysis', 2007, pp 1, 5, 8, http://global.marsh.com/documents/MarketConditionsAnalysis2006.pdf.

17 ibid, p 1.

pay major claims in multiple business lines) at reduced prices due to the capital market's reaction in the event of a terrorist attack, might lead to overall losses exceeding coverage and act as a significant disincentive.[18]

The CROs concluded that loss events beyond a certain scale surpass the risk capacity of the insurance industry and could be classified as uninsurable. Like Marsh, their view was that while the insurance market can meet the demand for insurance against most conventional terrorist attacks, for larger risks there is insufficient private capacity and a 'sensible solution' is for governments to provide some type of reinsurance that supports the provision of terrorism insurance. While acknowledging that there is no 'one-size-fits-all' solution, the CROs saw permanent private-public terrorism insurance partnerships between insureds, insurers, reinsurers, capital markets and governments, as essential to an effective solution.[19]

In September 2008, the US Government Accountability Office (GAO) reported to Congressional Committees on the status of efforts of policyholders to obtain terrorism insurance coverage. Amongst other things, the GAO examined factors limiting insurers' willingness to provide coverage in the US market. They found that commercial property terrorism insurance was widely available on a national basis at reasonable rates, largely due to TRIA and the 'soft' or competitive insurance market. The majority (around 60 per cent) of commercial clients were found to have purchased terrorism insurance at rates that had been generally stable since 2003 at around 4 per cent of commercial property premiums. Insurers' capacity to provide terrorism insurance was attributed to increased capital levels arising from strong profits, increased investment income and a lack of large losses from major catastrophes. It was also noted that a 'hardening' of the market, whether due to another terrorist attack, natural disasters or a decline in the value or investment portfolios, would result in reduced terrorism insurance capacity at current terms and prices.[20]

The availability of reinsurance was identified as a factor that might limit the supply and increase the price of terrorism insurance, particularly in high-risk locations. While reinsurance capacity had increased due to capital growth, the absence of another terrorist attack and improvements in insurers' ability to underwrite risk, reinsurers were still managing aggregation levels by limiting coverage, with location being an important factor in determining whether reinsurance is offered and at what price. Insurers and reinsurers also cited the views of credit rating agencies on the amount of capital allocated to terrorism risk and the location of risks as factors influencing the availability of terrorism cover.[21]

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18 op cit, CRO Forum, 'CRObriefing', pp 1-2.

19 ibid, pp 7-11.

20 United States Government Accountability Office, *Terrorism Insurance: Status of Efforts of Policyholders to Obtain Coverage*, report to Congressional Committees, September 2008, pp 9-12, http://www.gao.gov/new.items/d081057.pdf.

21 ibid, pp 20-22.

The GAO also found terrorism insurance to be less available and affordable in locations considered to be at higher risk of terrorist attack. To mitigate their risks, insurers set limits on the amount of coverage provided in these locations, or for buildings over a certain size or in close proximity to other high risk properties, and set premiums higher.[22]

In February 2009, Marsh estimated standalone terrorism insurance market capacity in the US and internationally of US$3,080 million. They also noted that, while market capacity is relatively stable, it can vary considerably depending on the location of the risk, individual insurers limiting capacity in particular locations due to the accumulation and concentration of exposure where demand for coverage is high, that is, metropolitan areas. Marsh reported that premium rates remained competitive in 2008 and, in some cases, more aggressively priced than more restrictive terrorism coverage embedded in property programs. They also reported that the global economic crisis began to affect the standalone terrorism insurance market in the fourth quarter of 2008, with premium rates flattening as insurers reacted to the uncertain business environment.[23]

Marsh has also commented that, while total standalone capacity is available in excess of $1.5 billion, it is more expensive and location sensitive.[24] Aon describes the standalone market as the market for 'difficult risks', noting that it has a history of global claims, relies on private capital commitments and is priced accordingly. It represents a relatively small proportion of the market, with government schemes accounting for most demand.[25]

Aon has assessed total 2009 total market per risk capacity at $US2.585 billion, with North America accounting for approximately 40 per cent of demand and South America, Eastern Europe and Asia being growth markets. Aon comments that non-US demand is driven by access to state pools and therefore accounts for less of the standalone market. In terms of the relative importance of the standalone market in the US, Aon notes that it accounts for 10 per cent of their clients. 'TRIA and non-certified coverage' accounts for 43 per cent of their clients, and 36 per cent choose not to purchase cover. Aon reported that, as of 31 March 2009, 63 per cent of its clients purchased some kind of terrorism cover, indicating that participation rates have been stable over the 2006 to 2009 period.[26]

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22 op cit, United States Government Accountability Office, *Terrorism Insurance*, pp 13-14, 16-17.

23 Marsh, 'Marketwatch: Terrorism Insurance 2009 — The Standalone Terrorism Market', First Quarter 2009, pp 1-2, http://global.marsh.com/documents/Marketwatch_Standalone_Terrorism_Market_Q1_2009.pdf.

24 ibid, p 2.

25 Aon Risk Services, 'Global Risk Alert: TRIA in Jeopardy', 14 May 2009, p 13, http://aon.mediaroom.com/index.php?s=65&item=349.

26 ibid, p 9, 13-14.

As part of its 2010 Budget, the US Government has announced its intention to reduce 'an excessive Federal subsidy' under the Terrorism Risk Insurance Program Reauthorization Act 2007 (TRIPRA), from 2011. The proposal draws on the findings of the PWG report of September 2006 that the property and casualty insurance market has improved its ability to absorb losses from a terrorist attack. It refers to reducing the subsidy as a means of encouraging the private sector to better mitigate terrorism risk through other means such as alternative reinsurance options and safer buildings. The proposal is estimated to generate savings of $263 million by 2014[27] when the US terrorism insurance arrangements under TRIA and its successors are due to expire.[28]

In response to the proposal and consistent with industry views on the terrorism insurance and reinsurance markets over the 2006 to 2009 period, Aon has commented that the proposal will reintroduce market uncertainty, reduce capacity, increase retention requirements and increase the price of terrorism insurance. Its view is that the proposal will disrupt the terrorism insurance market at a time when insurers and reinsurers are dealing with asset write-downs of 10 to 15 per cent since 2008, due to the global financial crisis. Aon also reports that the majority of insurers have indicated their intention not to provide cover in the absence of TRIA's mandatory requirements, and that 70 to 80 per cent of the commercial property market will revert to absolute exclusions.[29]

Australian market

The Australian general insurance industry is relatively well-positioned compared to its international counterparts, despite the global economic environment, difficult underwriting conditions due to weather-related events, and a significant fall in industry share prices. In the context of the global financial crisis, foreshadowed increases in premiums reflect insurers' concerns regarding reduced liquidity and the reduced value of investment portfolios, combined with natural catastrophe losses, rather than changes in their assessment of terrorism risk.

In its *Financial Stability Review* of March 2009, the Reserve Bank of Australia reported that the industry had post-tax profits of $2.2 billion in 2008 which, while less than in previous years, were consistent with the average for the 10 years to 2008. Profits were mainly attributable to conservative investment strategies with around three-quarters of financial assets held in fixed-income securities and less than 10 per cent held directly in equities, combined with no reported direct exposure to US sub-prime mortgage assets and associated structured investments. Insurers' holding capital was around twice the

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27 Savings are based on potential claims in the event of a terrorist attack. Source Aon Risk Services, 'Global Risk Alert: TRIA in Jeopardy', p 7.

28 United States Office of Management and Budget, *Terminations, Reductions and Savings: Budget of the US Government — Fiscal Year 2010*, Office of Management and Budget, Washington, DC, 2009, p 90, http://www.whitehouse.gov/omb/budget/fy2010/assets/trs.pdf.

29 op cit, Aon Risk Services, 'Global Risk Alert', pp 6-7.

regulatory minimum at mid-2008 and ratings agencies generally rate the industry highly at A+ or higher. However, aggregate claims increased by 33 per cent over 2008 compared to 3 per cent over the previous three years, partly due to significant weather-related events, and insurers recorded a loss on their underwriting business over 2008. There were increases in net premium revenue of around 4 per cent in 2008 compared to 2 per cent over previous years. Australian general insurers' share prices also fell significantly over 2008, but less than their US counterparts.

In terms of reinsurance, Australian general insurers ceded around one-quarter of gross premium revenue to reinsurers over 2008, mostly to large global reinsurers. Although they have sustained large investment losses and experienced large claims, also due to significant weather-related events, the majority of large global reinsurers are rated A or higher by Standard and Poor's.[30]

The National Insurance Brokers Association (NIBA) reported a hardening of the Australian insurance market in 2009, following generally soft conditions through 2008, due to the global financial crisis and weather-related events that are estimated to cost the Australian community $2.5 billion in insured losses. NIBA's view is that, while the Australian insurance industry has escaped much of the fallout from the global financial crisis, it represents the most important event impacting on the market in 2008 in terms of business confidence and investment decisions. Nonetheless, the Australian public retains confidence in the Australian prudential regulatory system and in the financial viability of Australian regulated insurers.[31]

Additionally, the attractiveness of national pooled arrangements, the established and well-understood nature of the scheme, the standard of the scheme's administration by the ARPC and the ARPC's highly regarded risk assessment and loss estimation modelling techniques, combine with high levels of participation[32] to make the Australian market relatively attractive to global reinsurers. Australia's geographic location allows reinsurers to diversify their risk and also contributes to the relative attractiveness of the Australian terrorism insurance market, although Australia remains at a 'medium' level of alert.[33]

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30 Reserve Bank of Australia, *Financial Stability Review,* March 2009, pp 34-36, http://www.rba.gov.au/PublicationsAndResearch/FinancialStabilityReview/Mar2009/Pdf/financial_stability_review_0309.pdf.

31 Noel Pettersen, 'Report on Australia by the National Insurance Brokers Association', undated, pp 1-3, http://www.niba.com.au/resource/Report%20on%20Australia%20for%20April%202009%20meeting%20doc.doc.

32 Insurers operating in the Australian market are not required to reinsure their terrorism risk with the ARPC. Some commercial reinsurance is available for insurers who choose to purchase it, but most insurers participate in the scheme, which is generally considered to be competitive compared to commercial alternatives.

33 Australia has been at a 'medium' level of alert since the four levels of national counter-terrorism alert were introduced in 2003.

In turn, the financial stability of the scheme, both through growth of the pool and the ARPC's purchase of retrocession, means that it supports financial stability for policyholders, insurers and financiers without placing undue financial pressure on insurers or policyholders, while continuing to meet its primary objective of protecting the Australian economy from the adverse effects of the withdrawal of terrorism insurance. See Chapter 3, which deals with Premiums and the Pool, and Chapter 4 on ARPC's Performance and Financial Stability of the Scheme, for further information.

Stakeholder views

Stakeholders consulted for the purposes of this review are uniformly of the view that, while global capacity for reinsurance of terrorism risk is returning for pooled arrangements, there is insufficient capacity at reasonable prices for individual risks. A small number of commercial providers compete with the scheme, but stakeholders consistently expressed the view that there are no commercial providers with the appetite or capacity to cover the risks covered by the scheme. This is consistent with views conveyed to both the PWG in the course of its study of the long-term availability and affordability of terrorism insurance, and the GAO in the course of its examination of terrorism insurance and the status of efforts of policyholders to obtain coverage.

Particular views were that:

- the scheme should continue to operate, under the ARPC's management, for at least another three years, at which time further examination of the availability of commercial reinsurance will need to be undertaken;
- although there has been some recovery in the terrorism insurance market since the scheme was introduced in 2003, the scheme is an efficient and effective mechanism supporting the provision of terrorism insurance, which remains limited in availability and restrictive in terms of price and policy conditions for individual insurers;
- the scheme provides a degree of financial stability for policyholders, insurers and investors that the private market cannot provide, particularly in the event of concentrated and catastrophic losses arising from a terrorist incident;
- the threat of terrorism continues to undermine insurance market confidence, resulting in reluctance for insurers to re-enter the market, although the availability of reinsurance is increasing;
- terrorism insurance is not readily or cost-effectively available through the commercial market, and in countries without similar schemes this has resulted in uneconomic costs and inadequate cover;
- without the backing of the scheme, there is limited appetite to provide terrorism insurance: insurers would be selective and some risks would not be placed;

- while there are some commercial alternatives to reinsuring with the scheme, capacity is insufficient and the scheme is not crowding out the private market;
- the availability of commercial reinsurance has been adversely affected by global economic conditions, with return on capital requirements and prices increasing as a result of the limited capital available to the market;
- the fact that the scheme is well known and understood in Australia creates certainty for the market in terms of the reinsurance response in the event of a terrorist incident, compared to commercial alternatives;
- the ARPC's purchase of retrocession has been achieved by virtue of the centralisation of risks under national pooled arrangements administered by the ARPC on behalf of the general insurance industry; and
- the scheme addresses the risks of anti-selection and represents a sustainable mechanism to ensure stability of cover 'post-event'.

Need for the Act to continue

Although the Australian general insurance industry is relatively well positioned despite the global economic environment and difficult underwriting conditions, it is, nonetheless, part of the international reinsurance market. Munich Re has commented that the effects of the global financial crisis, combined with underwriting losses due to severe weather-related events, are driving an increased demand for reinsurance. At the same time, reinsurers are facing the same pressures, leading to an increase in reinsurance prices.[34]

The global financial crisis has produced an unprecedented fall in reinsurance and insurance capital due to international equity pressures arising from collateralised debt obligations and the 'knock-on' effect of general revaluations. The additional effect of deteriorating underwriting performance and large hurricane losses also reduced industry capital. The impact on the insurance and reinsurance sector has been significant and far-reaching. Available reinsurance capital has reduced significantly as a result of asset revaluation taking place in the fourth quarter of calendar 2008.

Insurers will be focusing on returning to solid levels of underwriting profit and not relying on reserve leverage or investment earnings to supplement inadequate risk pricing. Industry's view is that premiums are expected to increase across the board and similar increases are expected for reinsurance. In response to insurance rate increases, it is likely that original policy holders will consider increasing deductibles or buying less cover as perceived asset values decrease.

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34 'Financial crisis increases demand for reinsurance', insuranceNEWS.com.au, 24 November 2008, http://www.insurancenews.com.au/analysis/financial-crisis-increases-demand-for-reinsurance.

These developments have occurred against an underlying shortage of reinsurance capacity for individual terrorism risks at affordable prices: a situation that has remained unchanged since 2006. Government schemes have been an important factor in addressing this shortage, encouraging market stability and protecting economies from the adverse effects of the withdrawal of terrorism insurance. The changes to TRIA and its successors demonstrate that the market is reactive to changes in government schemes, and Aon's view of the changes proposed in the US Government's 2010 Budget is that they could be 'the single biggest factor in terms of pricing and capacity for clients as we move through 2009 and into 2010 renewals'.[35]

In light of the underlying shortage of affordable reinsurance for terrorism risk and the final impact of the global financial crisis on the availability and affordability of reinsurance, which is as yet unknown, this review concludes that there is a need for Government involvement and for the Act to continue in operation for another three years to protect the broader Australian economy from the adverse effects of the withdrawal of terrorism insurance.

However, the scheme was established to operate only while terrorism insurance cover is unavailable commercially on reasonable terms, and maintain, to the greatest extent possible, private sector provision of terrorism insurance to the Australian market. Permanent government-subsidised reinsurance would remove any incentive for the private sector to develop alternative risk transfer mechanisms.

Recommendation

That the Act continues in operation, subject to a further review in no more than three years, at which time further examination of the availability of commercial reinsurance on reasonable terms be undertaken.

35 op cit, Aon Risk Services, 'Global Risk Alert', p 15.

CHAPTER 3: REFINEMENTS TO THE SCHEME

Subject to the Government's agreement to the need for the Act to continue in operation, this review considers refinements to the operation of the scheme in the following areas:

- premiums and the pool;
- retentions;
- line of credit facility;
- residential property; and
- postcode allocation.

3.1 PREMIUMS AND THE POOL

Issue

Whether reinsurance premiums payable to the ARPC should cease or be reduced once the premium pool reaches $300 million.

Background

Premiums

The *Terrorism Insurance Act 2003* (the Act) gives the ARPC the power to collect premiums for the reinsurance it provides.[1]

The ARPC covers eligible terrorism losses[2] for a declared terrorist incident covered by an eligible insurance contract where the insurer has a reinsurance agreement with the ARPC. An 'eligible insurance contract' is one that provides cover for loss or damage arising from the ownership or occupation of eligible property as defined in the Act, including associated business interruption losses and public liability claims.[3]

In Australia, the Act renders terrorism exclusion clauses in eligible insurance contracts ineffective in relation to loss or liabilities arising from a declared terrorist incident. Insurers who seek terrorism reinsurance through the ARPC pay premiums to the ARPC, although insurers may choose to reinsure with providers other than the ARPC. Insurers may pass on the cost of reinsurance to their policyholders through premiums. This is a commercial decision for the insurer.

Premiums paid to the ARPC replicate commercial arrangements where insurers choose to buy reinsurance.[4] The premium is calculated as a percentage of the premium to the underlying policy for insured property that falls within three tiers. The tiers are based

1 Paragraph 11(2)(a) of the Act specifies that the powers of the ARPC include the power to charge premiums in respect of contracts of insurance for which it is the insurer.

2 Section 3 of the Act defines an 'eligible terrorism loss' as a loss or liability arising from a declared terrorist incident, but does not include a loss or liability arising from the hazardous properties (including radioactive, toxic or explosive properties) of nuclear fuel, nuclear material or nuclear waste.

3 Section 7 of the Act defines an 'eligible insurance contract'. See the sub-chapter on Residential property for further information.

4 Premiums collected by the ARPC on behalf of the Government are retained and managed by the ARPC as an authority under the *Commonwealth Authorities and Companies Act 1997* (CAC Act). Premiums are collected by the ARPC in return for the financial service it provides, not to raise general government revenue. While the ARPC is established as a corporation under the CAC Act and operates on a not-for-profit basis, it provides a commercial grade service for which it charges a competitive price.

on geographic location and defined by postcode, having regard for the associated level of risk (Table 3.1.1).

Table 3.1.1: Definition of tiers by geographic location

Tier	Geographic location[(a)]
Commercial property and business interruption	
Tier A	Central Business Districts of Australian cities with a population greater than 1 million (Sydney, Melbourne, Brisbane, Perth and Adelaide)
Tier B	Urban areas of Australian capital cities and cities with a population greater than 100,000 (Sydney, Melbourne, Brisbane, Perth, Adelaide, Gold Coast, Canberra, Newcastle, New South Wales Central Coast, Wollongong, Hobart, Geelong, Sunshine Coast, Townsville and Darwin)
Tier C	Areas not allocated to Tiers A or B, and any property not on mainland Australia or Tasmania but within the coastal sea of Australia
Public liability	
None	Not applicable (see discussion later in this section)

(a) Insured property must be located on mainland Australia or within 12 nautical miles of the coast.

Premiums payable to the ARPC are set by ministerial direction.[5] They are not indexed but reflect changes in underlying premiums, which are a matter for each insurer to determine. In the event of a significant claim on the scheme, premiums payable to the ARPC would increase to enable the ARPC to finance its liabilities and rebuild the pool (Table 3.1.2).[6]

Table 3.1.2: Premiums payable to the ARPC

Tier	Annual premium payable to ARPC from 1 October 2003 Per cent of underlying premium	Maximum annual premium payable after a significant claim on the scheme Per cent of underlying premium
Commercial property and business interruption		
Tier A	12	36
Tier B	4	12
Tier C	2	6
Public liability		
None	Nil	2

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 and would not be a significant cost to smaller commercial property owners if passed on generally unchanged by insurers. As potential public liability costs are

5 Subsection 38(1) of the Act provides that the Minister may give written directions to the ARPC in relation to the performance of its functions and the exercise of its powers. Paragraph 38(2)(d) of the Act specifies that the directions that may be given under subsection (1) include directions setting premiums that are to be charged by the ARPC in respect of contracts of insurance. The current direction is Treasurer to Australian Reinsurance Pool Corporation (Premiums) Direction 2007.

6 Terrorism Insurance Bill 2002, Revised Explanatory Memorandum, paragraph 3.44, p 12.

difficult to quantify, in the absence of a significant claim on the scheme there is no initial premium payable for reinsurance of terrorism risk in this class of insurance. However, in the event of a significant claim on the scheme, reinsurance premiums would be required to be paid for public liability insurance.[7]

Pool

Once the ARPC has accounted for administration costs, the Act provides no direction on how it is to use the premiums collected. However, in 2002 the former Treasurer indicated that the ARPC should initially use premiums to fund a $300 million pool.[8] The ARPC has acted accordingly, with the pool reaching $300 million during 2006-07.[9]

Neither the Act nor the Ministerial Direction specify that premiums should change once the pool reaches $300 million. Unless the Minister directs otherwise, premiums will continue to be collected at current rates regardless of the pool size, which has grown over the life of the scheme (Table 3.1.3).

Table 3.1.3: Growth in the pool — 2003-04 to 2008-09

	Pool (cumulative)	Annual increase	
Year	$m	$m	%
2003-04	18.164	18.164	
2004-05	111.276	93.112	512.6
2005-06	220.697	109.421	98.3
2006-07	332.010	111.313	50.4
2007-08	456.644	124.634	37.5
2008-09 (est)	549.310	92.666	20.3

7 Terrorism Insurance Bill 2002, Revised Explanatory Memorandum, op cit, paragraph 3.44, p 12.

8 The Hon Peter Costello MP, Treasurer, 'Terrorism Insurance', media release no. 64, 25 October 2002.

9 The term 'pool' is used for the purposes of this discussion. This size of the pool is disclosed in the financial statements of the ARPC's Annual Reports as the 'Reserve for Claims'.

While premium revenue makes up the majority of the pool, investment revenue also contributes to its growth. Under section 34 of the Act and consistent with its status as an authority under the *Commonwealth Authorities and Companies Act 1997* (CAC Act), the ARPC may invest surplus money[10] in areas permitted by the CAC Act.[11]

Accordingly, the ARPC has pursued an investment strategy and as premium revenue has grown, so has the ARPC's capacity to invest. Over the 2003-04 to 2007-08 period, both premium revenue and investment revenue increased significantly. However, in 2008-09 interest rate reductions resulted in reduced growth in investment earnings (Table 3.1.4).

Table 3.1.4: Premium and investment revenue — 2003-04 to 2008-09

	Premium revenue		Investment revenue	
Year	$m	% increase	$m	% increase
2003-04	18.986		0.532	
2004-05	91.321	381.0	4.790	800.4
2005-06	102.537	12.3	10.833	126.2
2006-07	96.890	-5.5	18.803	73.6
2007-08	99.944	3.2	29.495	56.9
2008-09 (est)	101.011	1.1	30.208	2.4

Discussion

Cease or reduce premium collections

The 2006 review considered the issue of continued premium collections at existing rates in the context of suggestions from some stakeholders that the ARPC should cease collecting premiums once the pool reached $300 million.

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

10 Subsection 11(1) of the Act specifies that the ARPC has power to do all things necessary or convenient to be done for or in conjunction with the performance of its functions. Subsection 34(2) of the Act specifies that subsection 34(1), which deals with the application of money, does not prevent investment of surplus money of the ARPC under Division 3 of Part 3 of the CAC Act.

11 Subsection 18(3) of the CAC Act specifies that an authority may invest surplus money: (a) on deposit with a bank; or (b) in securities of the Commonwealth or of a State or Territory; or (c) in securities guaranteed by the Commonwealth, a State or a Territory; or (d) in any other manner approved by the Finance Minister. Subsection 18(5) of the CAC Act defines 'surplus money' as money of the authority that is not immediately required for the purposes of the authority.

- the ARPC be required to continue charging premiums for reinsurance at the current rates, subject to further review in no more than three years; and
- once the pool reaches $300 million, the ARPC have the discretion to determine whether to use premiums to build the pool further, purchase reinsurance for the scheme or undertake a combination of the two.[12]

In the context of this review, the pool has exceeded $300 million and the issues around continued premium collection and the size of the pool are largely unchanged. While there is unanimous support for continuation of the scheme, some stakeholders have raised questions in relation to:

- whether the ARPC should cease to collect premiums or continue to collect premiums at existing or reduced rates; and
- if the ARPC continues to build the pool, how funds can be used to enhance the financial stability of the scheme and provide increased protection to insureds through the purchase of retrocession at cost-effective rates.

The Government established the terrorism insurance scheme as an interim measure to operate only while terrorism insurance cover was unavailable commercially on reasonable terms. The scheme exists on a temporary basis to protect the wider Australian economy from the possible effects of a downturn in the commercial property sector arising from the withdrawal of terrorism insurance, and to protect the Australian financial system from concentrated losses in the event of a terrorist incident.

Recognising that in establishing the scheme the Government had assumed certain risks, the Government decided that any intervention should be consistent with, amongst other things, the need to:

- ensure that risk transferred to the Commonwealth is appropriately priced to minimise the impact on the Commonwealth's financial position, and to ensure that the Commonwealth is being compensated by those benefiting from the assistance; and
- maintain, to the greatest extent possible, private sector provision of insurance.

Taxpayers' interests need to be protected in terms of the risk the Government has assumed through its participation in the scheme in the form of the Commonwealth's $10 billion indemnity. Additionally, to allow the Government's eventual withdrawal from the scheme, the scheme needs to be structured in such as way as to avoid stifling the emergence of the commercial market and to encourage private sector involvement

12 The Treasury, *Terrorism Insurance Act Review: 2006*, op cit, pp 1, 58-59.

to the greatest possible extent. The ongoing collection of premiums is central to achieving both these outcomes.

If premium collections ceased, the Government would receive no compensation for providing a financial service through the ARPC. Removing the price from a service that is provided at a cost would be artificial and highly anti-competitive, making it impossible for commercial reinsurers, whether existing or new, to compete with the ARPC.

Growth of the pool would be totally dependent on investment income and commensurately vulnerable to any underperformance of investments. Over time, growth of the pool would be unlikely to keep pace with the value of risks covered, especially in terms of increasing property values, the emergence of new risks and the possible increase in the number of policies reinsured with the ARPC. In this regard, it is important to note that $300 million was an initial target for the size of the pool rather than an amount at which the pool should be capped, as such a cap would not reflect increases in the value and risk of insured properties over time.

As the value of the pool would erode over time, so would the overall sufficiency of the scheme, including the Commonwealth's $10 billion indemnity. A pool that was less reflective of property values, risk and any increase in the number of policies reinsured with the ARPC would mean that the Commonwealth's $10 billion indemnity would cut in sooner, depending on the value of claims against the pool, potentially exposing taxpayers to greater risk.

If claims exceeded $10 billion, the Minister would be required to specify a reduction percentage. This would ensure that the funds were distributed equitably, but each claim would not be met in full. If the pool was not reflective of property values, risk and any increase in the number of policies reinsured with the ARPC, this might result in a higher reduction percentage than would have been the case had premiums continued to be collected.

If the pool was effectively capped, new insurers and new policyholders would be treated inequitably, paying nothing for a service to which existing insurers and policyholders had made a significant contribution.[13] Further, if a declared terrorist incident occurred in relation to a building insured by a new policyholder, the pool would cover the loss but subsequent rebuilding of the pool through increased

13 The alternative of the scheme being closed to new insurers and policyholders would also be inequitable.

premiums would fall to new and existing insurers and policyholders, that is, both the benefits and costs would be allocated inequitably.[14]

The alternative of reducing premiums would also adversely affect the scheme's efficiency, effectiveness and equity. Although this may not occur to the same degree, the premiums payable to the ARPC are already competitive and any reductions would limit the ability of commercial insurers to compete.

A reduction in premiums would only be feasible if the terrorism risk associated with insured properties had reduced or the value and number of properties covered by eligible insurance contracts had reduced.

Terrorism risk in Australia

The risk of terrorism in Australia has not lessened. Australia remains at a 'medium' level of alert.

The National Counter-Terrorism Alert System is a range of four levels (low, medium, high, extreme) that communicate an assessed risk of terrorism to Australia. The Alert System guides national preparation and planning. It also dictates levels of precaution and vigilance to minimise the risk of a terrorist incident occurring. Australia has been at a medium level of alert since the four levels of national counter-terrorism alert were introduced in 2003.[15]

Cost and level of construction activity

Australian Bureau of Statistics (ABS) data indicate that the cost and level of construction activity, as well as the contribution of the construction industry to the Australian economy, continue to grow.

Over the 2002-03 to 2006-07 period, the price index for output of the general construction industry increased significantly. Between 2005-06 and 2006-07, the price indexes for output of the building construction and non-residential building construction components of the general construction industry increased by 4.2 per cent and 5.8 per cent respectively (Table 3.1.5).[16]

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14 New insurers could pay premiums to the ARPC while existing insurers cease to pay premiums or pay reduced premiums, depending on how long they had contributed to the scheme. This would have the same, and possibly greater, negative effects compared to reducing premiums for all insurers.

15 'National Counter-Terrorism Alert System', Attorney-General's Department, September 2008, http://www.nationalsecurity.gov.au/agd/WWW/NationalSecurity.nsf/Page/Information_for_Individuals_National_Security_Alert_System_National_Counter-Terrorism_Alert_System.

16 Australian Bureau of Statistics, *Year Book Australia, 2008*, cat no. 1301.0, Canberra, 7 February 2008, p 688.

Table 3.1.5: Price index of the output of the general construction industry — 2002-03 to 2006-07[a]

ANZSIC Subdivision/Group/Class[b]	2002-03	2003-04	2004-05	2005-06	2006-07
General construction	112.7	121.1	130.2	136.5	142.3
Building construction	112.4	121.2	130.6	136.8	142.5
Non-residential building construction	109.6	119.5	131.3	138.2	146.2

(a) Reference base year is 1998-99 = 100.0.
(b) Classified according to the Australian and New Zealand Standard Industrial Classification (ANZSIC), 1993 edition.
Source: ABS, Producer Price Indexes, Australia (6427.0).

Over the 2003-04 to 2007-08 period, the value of non-residential building work done in the private sector has also increased significantly. The half-year results for 2008-09 do not indicate a decrease on 2007-08, subject to activity being maintained in the second half of the year (Table 3.1.6).

Table 3.1.6: Building activity (private sector) — 2005-06 to 2008-09[a]

	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09[b] (half year)
Value of work done, total non-residential building						
$'000	13,680,599	15,873,568	18,721,771	21,109,910	25,353,129	14,342,437
% increase	18.9	16.0	17.9	12.8	20.1	–

(a) Australian Bureau of Statistics, *Building Activity, Australia*, Table 12, Value of Building Work Done by Sector, Australia, cat no. 8752.0, Canberra, December 2008.
(b) July 2008 to December 2008.

Between 1995-96 and 2005-06, the value of the construction industry production increased by 77 per cent and as a proportion of GDP, increased from 5.4 per cent to 6.4 per cent (Table 3.1.7).[17]

Table 3.1.7: Production and GDP[a][b][c]

	1995-96 $m	2005-06 $m	% increase
Construction	34,829	61,644	77.0
GDP	647,660	921,747	42.3
Construction as % of GDP	5.4%	6.4%[d]	1.0

(a) Industry gross value added at basic prices.
(b) Volume measures, reference year is 2004-05.
(c) Australian Bureau of Statistics, *Australia at a Glance*, 2008, Industry, cat. no. 1309.0, Canberra, February 2008, p 1.
(d) This calculates to 6.7 per cent. However, the *ABS Year Book Australia, 2008*, (p 582) states that 'In 2005-06 the construction industry's share of the total production of goods and services in the Australian economy GDP was 6.4 per cent'.

17 Australian Bureau of Statistics, *Year Book Australia, 2008*, op cit, p 582.

In 2006-07, the construction industry employed an average of 917,600 people, 4.7 per cent higher than in 2005-06. The number of employees increased by 9.0 per cent on 2005-06, while the number of employers and own account workers fell by 10 per cent and 2.8 per cent respectively. The majority of construction industry employment was in construction trade services (633,500 people or 69 per cent), which includes those engaged in services such as earthmoving, concreting, bricklaying, roofing, plumbing, electrical, carpentry, painting, glazing and landscaping.[18]

Retrocession

Assuming the ARPC continues to build the pool through the collection of premiums at existing rates, the question arises of how funds can be used to enhance the financial stability of the scheme and provide increased protection to insureds and the Australian Government through the purchase of retrocession at cost-effective rates.

The 2006 review observed that once the pool had reached $300 million, the ARPC could use premium income to increase the size of the pool or purchase reinsurance for the scheme. Both options would reduce the likelihood that the Government, and hence taxpayers, would be required to cover losses in the event of a terrorist incident. The 2006 review also observed that if the ARPC sought reinsurance for the scheme, this might encourage more commercial reinsurers to consider providing terrorism risk cover in Australia.[19]

In February 2009, the former Assistant Treasurer, the Hon Chris Bowen MP, announced that the ARPC had purchased retrocession for the scheme. After an investigation by the ARPC's Board of the availability of terrorism cover in the global reinsurance market and extensive negotiations, retrocession contracts were entered into with reinsurers from the Australian, European, Lloyd's and Bermudan markets. The retrocession was placed in excess of $300 million and gives the scheme additional capacity of $2.3 billion in the event of a declared terrorist incident. The cover started on 31 December 2008.[20]

The retrocession has been placed in excess of $300 million even though the reserve for claims stood at $456.6 million as at 30 June 2008. This increases the liquidity of the scheme in the event that a declared terrorist incident occurs early in the retrocession period. Funds available under these circumstances would be used to pay any outstanding retrocession premium, investigate reinstating the retrocessions, cover administration costs and rebuild the pool after a declared terrorist incident.

18 Australian Bureau of Statistics, *Year Book Australia, 2008*, op cit, p 582.

19 The Treasury, *Terrorism Insurance Act Review: 2006*, pp 57-58.

20 The Hon Chris Bowen MP, Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, 'Australian Government's Risk Under The Terrorism Insurance Scheme Reduced Through Purchase Of Retrocession', media release no. 6, 11 February 2009.

The purchase of retrocession has a number of benefits that increase the effectiveness of the pool: it gives the scheme additional capacity in the event of a terrorist incident, lessening the likelihood of a reduction percentage being required; it improves the financial stability and liquidity of the scheme, and enhances its credibility, thereby encouraging commercial involvement in the scheme and the terrorism insurance market more generally; and it reduces the Commonwealth's exposure to losses in excess of the pool.

A reduction in income through the cessation or reduction of premiums would adversely affect the ARPC's ability to purchase retrocession. As well as reducing the benefits that retrocession provides, this would have the effect of diminishing, rather than encouraging commercial involvement in the terrorism insurance market.

In terms of impact on the pool, retrocession premiums paid by the ARPC will partially offset reinsurance premiums paid to the ARPC by insureds and investment revenue earned, thereby slowing the growth of the pool. However, the benefits of the current retrocession arrangements to the scheme, as well as to insurers and the Commonwealth, outweigh the costs, and the purchase of retrocession has been widely supported by stakeholders in the context of the 2009 review.

Recommendation

That:

- the ARPC continue to collect premiums at current rates;
- the ARPC investigate using premium income to purchase further retrocession for the scheme; and
- the relationship between premiums and the pool, and the impact of retrocession on the pool and the scheme more generally, be further considered in the context of the 2012 review.

3.2 Retentions

Issue

Whether the current retention levels are sufficient to encourage greater involvement of the commercial insurance market in providing terrorism risk cover.

Background

The 2006 review recommended that retention levels under the scheme be increased in order to make them more comparable with commercial reinsurance and similar schemes overseas and to require commercial insurers to assume more terrorism risk. As a result, the *Treasurer to Australian Reinsurance Pool Corporation (Premiums) Direction 2007* required retentions to be increased in three increments, as set out below.

The last of the retention increases came into effect on 1 July 2009.

Table 3.2.1: Annual insurer and industry retentions

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

Discussion

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, which they can decide to 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 cover, and may marginally reduce the cost of retrocession coverage for the scheme, since insurers would be retaining a larger amount of risk at a lower layer of the scheme, which is more likely to suffer losses and therefore be more expensive.

Some comparable international schemes have raised retention levels since the 2006 review to encourage greater involvement of the commercial market. The US Terrorism Risk Insurance Program Reauthorization Act 2007 increased insurer retentions from 15 per cent of an insurer's direct earned premium for the previous year to 20 per cent. The government co-contribution to insurers' losses above this deductible was reduced from 90 per cent to 85 per cent. In addition, industry-wide maximum retention levels were increased from $15 billion in 2005 to $27.5 billion.[21]

Similarly, on 1 January 2007, France increased the amount that must be covered by commercial insurers and reinsurers for large- and medium-sized risks before the state guarantee applies under GAREAT 1 by €200 million to €2.2 billion.[22]

However, many comparable schemes have not raised retention levels since the last review in 2006, including in the United Kingdom.

Impact of retentions

For the 12 months to 31 March 2009, the ARPC reinsured the terrorism exposure of 251 insurers.[23] Of these, 187 are subject to the minimum $100,000 retention.

There are only a small number of insurers for whom 4 per cent of fire and ISR premium collected is greater than $5 million, and who were therefore affected by the increase in the maximum insurer retention from $5 million to $10 million on 1 July 2009.

The ARPC advises that there are no insurers for whom 4 per cent of fire and ISR premium collected is significantly greater than $10 million. Therefore, increasing maximum annual insurer retentions further at this time would have little or no practical impact on the amount insurers would have to retain.

Industry-wide, insurers now retain $105.3 million annually since the increased maximum insurer retention level came into effect. As insurers' combined annual retentions are marginally higher than $100 million, increasing the maximum industry retention per event would have little impact and not significantly increase private sector involvement in the scheme.

21 United States Department of the Treasury, 'Interim Guidance Concerning the Terrorism Risk Insurance Reauthorisation Act of 2007', op cit, p 5,265.

22 Guy Carpenter, 'Global Terror Insurance Market', op cit, June 2007, p 10.

23 ARPC advice dated 25 June 2009 for the four quarters June 2008, September 2008, December 2008 and March 2009. During the 12 months to 31 March 2009, the ARPC had 251 cedants. However, as of 25 June 2009, the ARPC only had 241 cedants, as 10 cedants that remitted premium during the 12-month period also cancelled their contracts during that period. The figures used in this section are based on the 251 cedants that remitted premium to the ARPC during the 12-month period to 31 March 2009.

However, these figures are based on gross fire and ISR premium collected for the 12 months to 31 March 2009. It is expected that gross fire and ISR premium will continue to increase over the next three years, and it therefore may be prudent to re-examine retention levels in the course of the 2012 review.

Stakeholder views

Consultations with stakeholders indicate that a small number of insurers, particularly at the smaller end of the market, have reinsured their retentions. This is particularly the case where the terrorism retention is of a similar size to non-terrorism retentions, and the terrorism retention is sometimes reinsured in combination with related non-terrorism retentions, such as travel. Where insurers have reinsured their retentions, it appears to have been placed offshore.

Stakeholders have suggested that, overall, there would likely be very little appetite from reinsurers to reinsure retentions, as it would involve greater exposure to terrorism risk at a low attachment level, which is the most difficult risk to understand and manage. Coverage would also be on a piecemeal basis with individual insurers, and therefore would not have the benefit of the uniformity, transparency and diversification of risks that the ARPC pool provides, as seen in its successful placement of retrocession cover.

The ARPC is of the opinion that the appetite for terrorism insurance is still low, capacity is not readily available at reasonable rates, and any further increases in retentions will exacerbate the difficulties insurers have in obtaining cover to reinsure their retentions. The ARPC considers that the current retention levels reflect current market conditions and that industry should be allowed to adjust to the new retentions before further increases are considered.

The Insurance Council of Australia has also indicated that, while insurers have accepted the increased retentions arising from the 2006 review, its members would be unlikely to support further increases.

Recommendation

That industry retention levels remain at the levels that took effect on 1 July 2009. However, the appropriateness of the current levels and structure of retentions should be re-examined in the course of the 2012 review.

3.3 LINE OF CREDIT FACILITY

Issue

Whether the $1 billion line of credit facility previously purchased by the ARPC is still required, given the increased cost of the facility and that a significant pool from which to pay claims now exists.

Background

When the terrorism insurance scheme was established in 2003, a $1 billion line of credit facility was instituted to supplement the reinsurance pool. The due repayment of this line of credit was guaranteed by the Commonwealth. Above these layers, the Commonwealth provides a $9 billion indemnity to the scheme. These arrangements were intended to provide aggregate cover of up to $10.3 billion once the pool reached its initial target of $300 million.

The contract to provide the line of credit facility was put to a competitive tender process by Treasury in 2003 and awarded to ABN Amro. The original facility was for the period 18 August 2003 to 30 June 2006. Before the expiry of the term of the facility, ABN Amro offered the ARPC an extension, to which the ARPC Board agreed in early 2006. The current facility expired on 30 June 2009.

Table 3.3.1: Structure of the terrorism insurance scheme prior to and following expiry of the line of credit facility

Layer	Element up to 30 June 2009	Element from 1 July 2009
Layer 1	Policyholder's liability	Policyholder's liability
Layer 2	Retention of some risk by insurers	Retention of some risk by insurers
Layer 3	ARPC pool, deemed at $300 million	ARPC pool, deemed at $300 million
Layer 4	Retrocession layer 1: $300 million excess of $300 million	Retrocession layer 1: $300 million excess of $300 million
	Retrocession layer 2: $1.6 billion excess of $600 million	Retrocession layer 2: $1.6 billion excess of $600 million
	Retrocession layer 3: $400 million excess of $2.2 billion	Retrocession layer 3: $400 million excess of $2.2 billion
Layer 5	Commercial line of credit for up to $1 billion, incepting at $2.6 billion of losses, guaranteed by the Commonwealth	Commonwealth Government indemnity for up to $10 billion, incepting at $2.6 billion of losses
Layer 6	Commonwealth Government indemnity for up to $9 billion, incepting at $3.6 billion of losses	Possible liability for some risk by policyholders through the operation of the reduction percentage or policy limits, for losses excess of $12.6 billion
Layer 7	Possible liability for some risk by policyholders through the operation of the reduction percentage or policy limits, for losses excess of $12.6 billion	

The expiry of the current line of credit facility offers the chance to review its continued need, in light of developments both since the scheme was established and since the initial extension of the facility in 2006.

Discussion

Liquidity

The original rationale for the inclusion of a line of credit facility in the scheme was to ensure that the ARPC had access to liquidity in the event of a declared terrorist incident in the early years of the scheme while the pool was relatively small. In the absence of the line of credit, the Commonwealth indemnity, and therefore taxpayer funds, would have been called upon immediately in the event of a declared terrorist incident.

A condition of the line of credit contract was that the funds would be made available within three days of the ARPC making a request to the facility provider.

At the time of the first expiry of the facility, the ARPC's reserve for claims was $220.697 million. The ARPC pool has since significantly surpassed its initial $300 million target, and stood at approximately $550 million as at 30 June 2009. The ARPC estimates that, all else being equal, by the end of the 2011-12 financial year (the time of the next review and the date on which a three-year line of credit facility would likely expire), the reserve for claims will be approximately $700 million.[24]

As a result of the continued collection of premiums and investment income, the ARPC is no longer subject to the liquidity constraints it had when it was first established, or even when the facility was extended in 2006. The ARPC is subject to requirements under the *Commonwealth Authorities and Companies Act 1997* in relation to the investment of surplus monies, which limits the products it can invest in, significantly reducing the risk of investment losses.[25] In addition to complying with these requirements, the ARPC has in place agreements to ensure that it can access its funds within three days of making a written request to the relevant institution. These two factors ensure the financial stability and liquidity of the scheme by ensuring that the ARPC will be able to access the funds in the pool in a timely manner if required.

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24 ARPC advice to Treasury 10 June 2009.

25 Subsection 18(3) of the *Commonwealth Authorities and Companies Act 1997* provides that an authority regulated by the Act may invest surplus money: (a) on deposit with a bank; or (b) in securities of the Commonwealth or of a State or Territory; or (c) in securities guaranteed by the Commonwealth, a State or a Territory; or (d) in any other manner approved by the Finance Minister. Surplus money is defined as the money of the authority that is not immediately required for the purposes of the authority. In the context of the ARPC, this largely refers to the pool as, in the absence of a DTI requiring the ARPC to pay claims, the funds in the pool are not required immediately.

The ARPC's purchase of retrocession for the scheme has also increased the funding available above the pool by $2.3 billion. The ARPC's retrocession agreements include provisions to ensure that it will not be subject to liquidity constraints as a result of timing gaps between making payments under claims received from insurers it reinsures and seeking reimbursement from its retrocessionaires.

The retrocession agreements also include provisions in relation to counterparty security to protect the ARPC against default by any of the retrocessionaires, including minimum credit rating criteria. See Chapter 6 for further information on the ARPC's retrocession program.

The structure of the retrocession program also ensures that the pool will not be exhausted after one incident and that the ARPC will have funding available to meet its costs. Retrocession coverage would be triggered once eligible losses for the ARPC exceed $300 million. Based on its cash and investment position of approximately $570 million as at 30 June 2009, the ARPC would still have $270 million in funds available. These funds would be used to pay costs such as the balance of the retrocession premium for the policy period (which is required before the ARPC can seek reimbursement from its retrocessionaires), to investigate reinstating the retrocession (to ensure the ARPC is protected by retrocession for any subsequent terrorist incidents) and ongoing administration expenses. Even with these additional expenses, the ARPC would be expected to have significant funds available to serve as the basis for rebuilding the pool. This sum will continue to increase over time as the ARPC continues to collect premiums and earn investment revenue.

Additionally, the significant funds that the ARPC would have available following a declared terrorist incident reduces the likelihood that the Minister would need to increase the premiums the ARPC charges for providing reinsurance to rebuild the pool.

As a result of the size of the pool and the retrocession program, the line of credit would be unlikely to be called upon unless eligible claims exceeded $2.6 billion. The ARPC therefore has a significant buffer of liquid assets to draw upon in the event of a declared terrorist incident, even one which would potentially result in high levels of eligible losses under the scheme.

It is intended that the ARPC will continue to purchase retrocession in future years, subject to market capacity and pricing representing value for money.

Commonwealth indemnity and pricing

Under the terms of the recently expired facility, the ARPC was charged an annual fee to maintain the facility, with any borrowing under the facility incurring an additional charge. Any borrowed amounts would then have to be repaid within a stipulated timeframe, with the repayment guaranteed by the Commonwealth.

Under the Act, the Commonwealth guarantees the due payment of the liabilities of the ARPC, up to $10 billion.[26] This $10 billion indemnity includes the Commonwealth's obligations as guarantor of the ARPC's line of credit facility. As such, having a line of credit in place does not reduce the Commonwealth's total potential exposure to the scheme as, in the event that the ARPC is unable to recoup its losses in time to repay the line of credit, the Commonwealth would be forced to repay some or all of the facility. This means that the Commonwealth would, via the indemnity, essentially be providing a similar service as the line of credit, but the ARPC would be paying a fee to the facility provider for the ability to access $1 billion of funds within three days.

If liquidity in the scheme is no longer of significant concern, the value gained from the ARPC incurring interest charges for any borrowing under the facility, as well as paying the annual maintenance fee, is significantly less than it was when the scheme was established, and will continue to diminish over time as the pool continues to grow.

With the expiry of the facility on 30 June 2009, the ARPC has investigated the pricing and other terms of a new facility. Pricing has significantly increased as a result of the impacts of the global financial crisis, to the point where it may not represent value for money, which only further exacerbates the cost issues outlined above.

As noted above, if the Government were to determine that the line of credit was no longer necessary, the overall Commonwealth guarantee of losses to the scheme above the pool and retrocession would remain at $10 billion. This would not require any legislative change, as the requirement for the ARPC to maintain a line of credit facility was a policy decision of the Government when the scheme was established and agreed to by the ARPC, not a legislative requirement.

Efficient use of funds

In the event that the ARPC is no longer required to maintain a line of credit facility, the question arises as to what the ARPC should do with the funds it would, under the proposed terms of any new facility, otherwise have used to maintain the line of credit. One option would be for the ARPC to retain the funds as cash and investments. However, while the cost of a new facility has increased significantly, it is not a large sum of money compared with the ARPC's $570 million in cash and investments. As a result, there would be no material increase in the pool and therefore no material distancing of the Commonwealth from potential liabilities under the scheme.

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26 Under subsection 35(1), the Commonwealth guarantees the due payment of money that may become payable by the ARPC to any person other than the Commonwealth. Subsection 6(7) requires the Minister to declare a reduction percentage if, in the absence of a reduction percentage, the total amounts paid or payable by the Commonwealth under section 35 (including amounts not related to the act or acts specified in the 'Declared Terrorist Incident') would be more than $10 billion.

Additionally, one of the underlying principles of the scheme is that it should maintain, to the greatest possible extent, private sector provision of terrorism insurance. Retaining the funds in the pool would provide no additional encouragement for greater private sector participation in the provision of insurance for terrorism risks.

Another option would be for the ARPC to use the funds to obtain greater retrocession coverage for the scheme. This would both increase the funding the ARPC has available to pay claims prior to calling on the Commonwealth indemnity, as well as further increase the involvement of the private sector in the provision of terrorism insurance.

Guy Carpenter, the ARPC's retrocession broker, believes that there is some additional market capacity for reinsurance of the Australian scheme, at a reasonable cost.[27] Firm indications of the amount of additional capacity and pricing would be determined in the course of the ARPC and Guy Carpenter's investigations for the renewal of the retrocession program in the second half of 2009.

Recommendation

That:

- the ARPC not be required to maintain a line of credit facility for the scheme, guaranteed by the Commonwealth at the current time;
- the ARPC should investigate purchasing additional retrocession capacity for the scheme with the funds that would otherwise have been used to pay the maintenance fee for the line of credit; and
- the ARPC should continue to monitor its overall liquidity position and the need for a line of credit or other liquidity source in light of market retrocession capacity and pricing and any other relevant factors.

27 Advice from Guy Carpenter to the ARPC, April 2009.

3.4 Residential property

Issues

Whether the scheme should be extended to include:

- high-rise buildings that are predominantly or wholly for residential use; and
- defence force and student accommodation involving commercial property financing.

Background

Following the withdrawal of terrorism insurance in the wake of the September 2001 terrorist attacks, the impetus for establishing Australia's terrorism insurance scheme was the Government's concern that the lack of comprehensive insurance cover for commercial property or infrastructure would adversely affect financing and investment in the Australian property sector, with subsequent negative macroeconomic effects.

At that time, the widespread withdrawal of terrorism cover from commercial insurance policies was making it difficult for developers to obtain financing for large construction projects. This had the potential to cause a decline in construction that would eventually lead to a downturn in the property sector, with negative flow-on effects for the wider economy.

For this reason, the scheme is confined to insurance relating to commercial property, and business interruption and public liability in relation to commercial property. Other classes of insurance such as private residential property, marine and aviation insurance are excluded from the scheme. Similarly, the scheme does not extend to damage resulting from nuclear causes, farms that do not have business interruption cover, workers compensation insurance and insurance that covers Commonwealth, State and Territory governments.[28]

The lack of terrorism cover also meant that, in the event of a terrorist incident, the Australian financial system might be at risk. This was because a terrorist incident resulting in large concentrated losses to one or more financial institutions could result in those institutions' failure, with consequent shocks to the broader financial system.

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28 The scheme does, however, extend to Commonwealth and state business enterprises as well as Commonwealth-owned airports leased commercially. Source: ARPC, 'Frequently Asked Questions', http://www.arpc.gov.au/content/faqs.asp?NavID=5.

As a result, the scheme is structured to protect the interests of commercial property owners, developers and lenders where commercial property owners would otherwise be unable to obtain terrorism insurance. This is achieved through the operation of the *Terrorism Insurance Act 2003* (the Act) and the *Terrorism Insurance Regulations 2003* (the regulations), specifically through the definitions of an 'eligible insurance contract' and 'eligible property'.

An 'eligible insurance contract' is defined in section 7 of the Act and section 7(1) refers to 'eligible property', and business interruption and liability in relation to eligible property.[29] Amongst other things, section 7(2) specifies that a contract is not an eligible insurance contract to the extent to which it is prescribed by the regulations.[30] The regulations effectively confine 'eligible property' to commercial property.

In terms of residential property, regulations 2(a) and 2(b) exclude home buildings and contents of a residential building within the meaning given by regulations 7.1.12 and 7.1.13 of the *Corporations Regulations 2001*. However, under regulation 7.1.12, buildings under construction are excluded from the definition of 'home building'. In the case of commercial property developments, this means that the relevant insurance contracts fall within the scheme during the construction phase, regardless of whether the property is ultimately for residential or commercial use. It is not until the building is completed and the residences are sold that insurance on that structure is no longer considered an 'eligible insurance contract'.

Structuring the scheme in this way has resulted in developers and lenders being largely unaffected by the withdrawal of terrorism insurance. Specifically, the withdrawal of terrorism insurance has not affected the availability of finance for the construction of high-rise buildings, regardless of their end use, and the risks to the financial system have been limited where lenders provide debt financing for commercial building projects covered by the scheme.

29 'Eligible property' is defined in section 3 of the Act as the following property that is located in Australia: (a) buildings (including fixtures) or other structure or work on, in or under land; (b) tangible property that is located in, or on, property to which paragraph (a) applies; and (c) any other property prescribed by the regulations. The definition includes a note to the effect that roads, tunnels, dams and pipelines are examples of eligible property.

30 Paragraph 7(2)(b). Paragraph 7(2)(a) specifies that a contract is not an eligible insurance contract to the extent to which it is a contract of reinsurance.

In terms of completed buildings, to determine whether an insurance contract relates to a commercial or residential building (and hence whether the Act applies), an insurer must determine whether the building in question is predominantly (more than 50 per cent of the area of usage or intended usage) commercial or residential, unless other considerations apply.[31]

An insurance contract issued in relation to a building that is determined to be predominantly commercial is an 'eligible insurance contract' under the Act. An insurance contract issued in relation to a building that is determined to be predominantly or wholly for residential use is not an 'eligible insurance contract' and the building is not covered by the scheme. Owners of such buildings must bear their own terrorism risk or seek commercial terrorism cover.

Discussion

The issue of extending the scheme to include predominantly or wholly residential high-rise buildings was examined in the 2006 review on the basis that the risk to these buildings from a terrorist incident may be similar to the risk for a commercial high-rise building. Stakeholders' views were that it may be difficult for developers to sell such residences following a terrorist incident, where terrorism cover was unavailable. Any such reduction in sales would have a direct impact on property developers and other intermediaries in the property sector, which might lead to a slowdown in the sector generally and negative flow-on effects for the wider economy. Including residential high-rise building in the scheme was proposed to pre-empt and negate the effect of this possible economic impact.

The review did not support the extension of the scheme to include predominantly or wholly residential high-rise buildings. It concluded that there was no evidence to suggest that either the willingness of lenders to provide finance for residential developments, or sales of residential apartments in high-rise buildings, had reduced due to the withdrawal of terrorism insurance. The review also concluded that the increased transfer of cost and risk from property owners to the Government would substantially increase the costs of the scheme while producing limited benefits.[32]

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31 The ARPC advises that other factors should be considered, particularly where the residential percentage use factor is in the range of 40 to 60 per cent. Other factors are also relevant where a significant portion of the building is unoccupied and is likely to remain unoccupied even though it may ultimately be intended for a particular use. Where further analysis is required, it should focus upon the degree, extent and intensity of use or intended use of the building for its various purposes. Source: Frequently Asked Questions at http://www.arpc.gov.au.

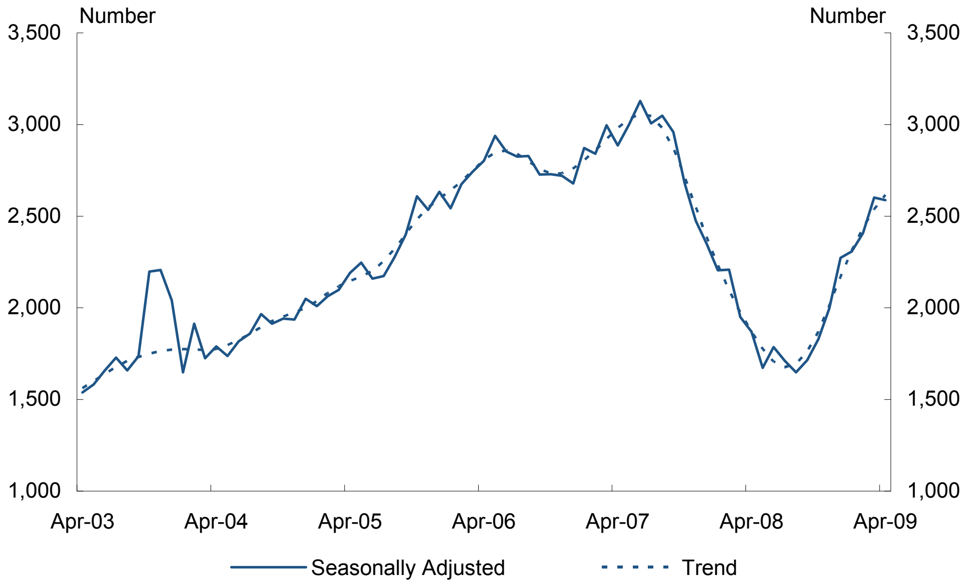
32 The Treasury, *Terrorism Insurance Act: Review 2006*, op cit, p 50.

Lending and construction activity

Updated data shows that there continues to be no evidence that the withdrawal of terrorism insurance is having an adverse affect on the number or value of finance commitments for the purchase of new dwellings, the number and value of approvals for construction of units in new residential buildings, or the number of dwelling unit commencements.

Australian Bureau of Statistics data shows that the number of finance commitments for the purchase of new dwellings[33] for owner occupation (trend) increased by 90.9 per cent from 1,561 in April 2003 to 2,980 in April 2007 then, after a decline of 37.4 per cent to 1,887 in April 2008, increased by 40.1 per cent to 2,616 in April 2009. The seasonally adjusted series increased by 87.6 per cent from 1,539 in April 2003 to 2,887 in April 2007 then, after a decline of 35.2 per cent to 1,870 in April 2008, increased by 38.5 per cent to 2,589 in April 2009.[34] Graph 3.4.1 shows the recovery that occurred to April 2009, following a period of overall decline between June 2007 and August 2008.

Graph 3.4.1: Housing finance commitments (owner occupation)
Purchase of new dwellings — number

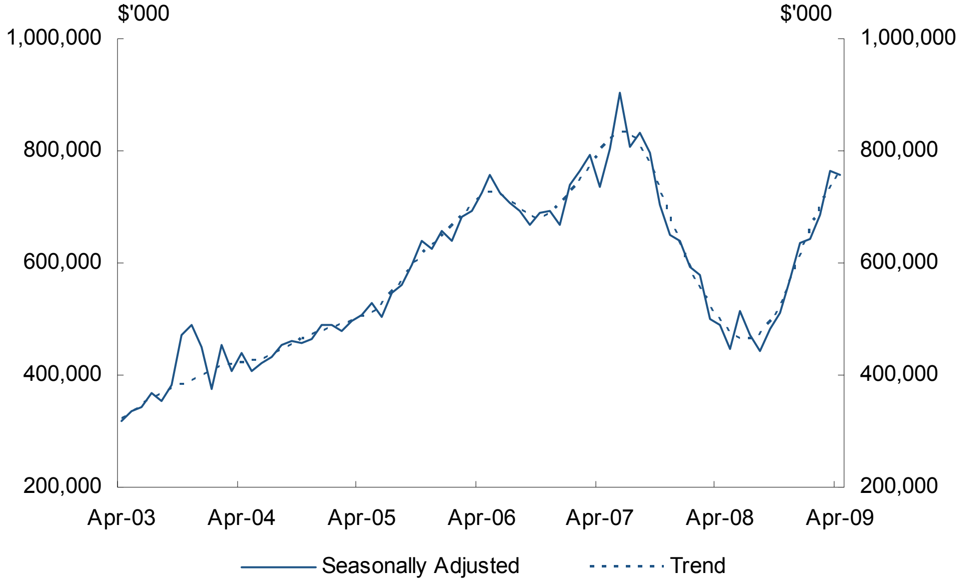


33 The ABS defines a dwelling as 'a single self-contained place of residence such as a detached or semidetached house, a terrace house, a flat, home unit, town house etc'. Apartments in high rise buildings are 'dwellings' but would represent a relatively small proportion of total dwellings. Source: Australian Bureau of Statistics, *Housing Finance*, cat. no. 5609.0, Canberra, April 2009, p 27.

34 ibid, Time Series Spreadsheets, Table 1, Housing Finance Commitments (Owner Occupation) by Purpose: Australia (Number), April 2009.

The value of finance commitments for the purchase of new dwelling for owner occupation followed a similar pattern. Graph 3.4.2 shows a period of overall increase between April 2003 and June 2007 followed by a decline between July 2007 and July 2008 and a period of recovery from August 2008 to April 2009.[35]

Graph 3.4.2: Housing finance commitments (owner occupation)
Purchase of new dwellings — value $'000



However, the economic downturn of 2008-09 and reduced availability of credit are having a negative impact on dwelling unit approvals.

The number and value of approvals for construction of new flats, units or apartments in buildings of four of more storeys increased steadily from 2005-06 to 2007-08. The part-year results for 2008-09 indicate a decrease on 2007-08, but this is consistent for all new residential buildings, regardless of whether they are detached houses, or flats, units or apartments in single or multi-storey buildings. That is, the year-to-date results for 2008-09 are not attributable to terrorism risk and insurance. Further, the number and value of approvals for flats, units or apartments in buildings of four storeys or more have increased at a faster rate than for detached houses (Table 3.4.1).

35 Australian Bureau of Statistics, *Housing Finance*, Time Series Spreadsheets, Table 1, Housing Finance Commitments (Owner Occupation) by Purpose: Australia (Value, $000), op cit.

Table 3.4.1: Dwelling units approved in new residential buildings: 2005-06 to 2008-09[(a)]

	2005-06	2006-07	2007-08	2008-09[(b)] (part year)
Flats, units or apartments in a building of four or more storeys				
Approvals	16,035	17,859	21,530	13,208
% change		11.4	20.6	–
Value ($m)	4,132.4	5,040.8	6,905.0	4,282.6
% change		22.0	37.0	–
Detached houses				
Approvals	105,298	106,083	109,350	75,885
% change		0.7	3.1	–
Value ($m)	21,989.0	24,038.0	26,588.5	18,833.6
% change		9.3	10.6	–

(a) Australian Bureau of Statistics *Building Approvals*, cat. no. 8731.0, Canberra, 2 June 2009, p 18.
(b) July 2008 to April 2009.

Master Builders Australia reported on 1 July 2009 that tight lending and strict pre-sale requirements were driving a reduction in approvals of investor-driven units, apartments and townhouses. According to the Master Builders' survey, the availability of finance is a concern for builders and developers but, provided the situation eases as expected, a recovery in dwelling approvals should lead to an improvement in residential building activity in 2010. The monthly survey found that private sector house approvals fell by 2 per cent to 7,831 in May 2009, an 8.5 per cent reduction on May 2008. This compares to approvals for 'other dwellings', including apartments and townhouses, which fell by 43.6 per cent in May 2009 to be 57.5 per cent lower than in May 2008.[36]

Dwelling unit commencements data show generally increased activity from 2005-06 to 2007-08 and that growth in 'other residential buildings' commencements, including flats, units, townhouses and apartments, was significantly stronger than for housing commencements in 2007-08 (Table 3.4.2).

36 Master Builders Australia, 'Investors Sit on the Sidelines as Approvals Fall Back', 1 July 2009, http://www.masterbuilders.com.au/NewsArchive.asp.

Table 3.4.2: Dwelling unit commencements (private sector): 2003-04 to 2008-09[(a)]

	2005-06	2006-07	2007-08	2008-09[(b)] (part year)
Other residential buildings including flats, units, townhouses, apartments etc				
	44,628	42,531	47,725	28,877
% change	-9.6	-4.7	12.2	–
Detached houses				
	102,432	104,641	105,298	67,808
% change	-2.0	2.2	0.6	–

(a) Australian Bureau of Statistics *Dwelling Unit Commencements*, cat. no. 8750.0, Canberra, 17 June 2009, p 7.
(b) July 2008 to March 2009.

More recent data show that the economic downturn and reduced availability of credit are having a negative impact on dwelling unit commencements. The number of private house commencements fell by 4.1 per cent to 21,428 in the March 2009 quarter, a reduction of 16.3 per cent on the March 2008 quarter. This compares to commencements of 'other dwellings', including apartments and townhouses, which fell by 6.6 per cent in the March 2009 quarter, a reduction of 34.9 per cent over the year. However, as the availability and affordability of finance eases, Master Builders Australia expects a 25 per cent increase in annualised dwelling commencements over the next year as the investor-driven sector rejoins the market.[37]

Impact of extending the scheme

Including residential high-rise buildings would increase the overall risk assumed by the scheme and possibly impact on its sustainability, particularly if it was unable to diversify that risk by including all residential property consistent with the scheme's treatment of commercial property. Although there is a trend towards people living in flats, units and apartments, including in high-rise buildings, households remain heavily weighted towards separate houses and contributions from these households would be highly disproportionate to the allocation of risks and benefits within the scheme.

In 2001, 83 per cent of people living in private dwellings were living in separate houses and 2 per cent were living in high-rise units (residential units in apartment blocks of four or more storeys).[38] Of the 7.9 million households living in private dwellings in 2005-06, 79 per cent were living in separate houses and 11 per cent were living in flats, units or apartments. While this indicates a trend away from living in separate houses,

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37 Master Builders Australia, 'Dwelling Starts Hit Bottom', 17 June 2009, http://www.masterbuilders.com.au/NewsArchive.asp.

38 Australian Bureau of Statistics, *Australian Social Trends, 2004*, Housing, High Rise Living, cat. no. 4102.0, Canberra, 15 June 2004, p 1.

the 2005-06 measure is not directly comparable as it does not separately identify residential units in apartment blocks of four or more storeys.[39]

Assuming the scheme applied to all residential property and insurers passed on their costs to the scheme, the 2006 review estimated that home owners would pay additional premiums of $114 million.[40] Using the same methodology, estimated additional premiums would be $140 million as at 30 June 2008.[41]

If the scheme were extended to include residential buildings, it is unclear whether the reserve for claims would be sufficient to cover all insured losses in the event of a terrorist incident. If it was insufficient, the Commonwealth and Australian taxpayers would be exposed to greater risk.

With the scheme assuming greater risk, the risk of the Government's $10 billion indemnity being insufficient is also greater. If claims on the scheme exceeded $10 billion, the Minister would be required to specify a reduction percentage. This would ensure that the funds were distributed equitably, but each claim would not be met in full. Further, the reduction percentage may be higher than it would have been had residential buildings continued to be excluded from the scheme.

Introduction of residential policyholders also has the potential to introduce considerable inequity to the scheme. If a declared terrorist incident occurred in relation to a building insured by a new policyholder, the loss would be covered from a pool to which they had not contributed equally, but subsequent rebuilding of the pool through increased premiums would fall to new and existing insurers and policyholders, that is, both the benefits and costs would be allocated inequitably.

This raises the question of whether the introduction of residential property to the scheme would necessitate the creation of a separate pool, and possibly other separate arrangements in relation to policyholder premiums, insurer retentions and the ARPC's retrocession arrangements.

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39 Australian Bureau of Statistics, *Year Book Australia, 2008*, Housing, Types of Dwellings, cat. no. 1301.0, Canberra, 7 February 2008, p 1.

40 The Treasury, *Terrorism Insurance Act Review: 2006*, op cit, p 49.

41 The ABS *Year Book Australia, 2008* indicates that, as at 30 June 2006, 75 per cent of the Australian population lived in urban areas with populations of 100,000 or more (using the scheme's Tier 1 and Tier 2 definitions). If all insurance for residential property were covered by the scheme, 75 per cent of homeowners would be charged at least an additional 4 per cent on their home insurance premium for terrorism cover and 25 per cent would be charged an additional 2 per cent. Based on gross premium revenue of $4,012 million for houseowners/householders' insurance for the year to 30 June 2008, this would equate to at least an additional $120.4 million for home owners in urban areas and an additional $20.1 million for home owners in other areas. Source: Australian Prudential Regulation Authority, *Half Yearly General Insurance Bulletin 30 June 2008* (Table 7: Industry premiums and claims by class of business), 25 May 2008.

While these arguments generally hold true for new commercial policyholders and insurers joining the scheme, the issues are ones of scale and timing of impact. New commercial risks add to the scheme incrementally, expanding coverage with successive but marginal financial impacts. Extending the scheme to include residential buildings would introduce a new category of risk and create a significant financial impact, particularly over the year from the date of introduction.

Commercial terrorism insurance

The Government established the terrorism insurance scheme as an interim measure to operate only while terrorism insurance cover was unavailable commercially on reasonable terms. Recognising that the Government had filled a market gap (albeit for broader policy reasons) and in doing so had assumed certain risks, the Government decided that any intervention should be consistent with, amongst other things, the need to maintain, to the greatest extent possible, private sector provision of insurance. With respect to high-rise property that is solely for residential use, there is an emerging market for commercial terrorism insurance in Australia.

CHU, a specialist underwriting agency owned by QBE, offers an insurance product on all Residential Strata Insurance Plans and Community Association Plans (residential risks) with a Building Sum Insured of $50 million or less. The cover is effective on all renewals and new business with inception dates from 1 April 2007.

In its *Terrorism Cover Fact Sheet*, CHU states that it will no longer apply a blanket terrorism exclusion to its Residential Strata Insurance Plan or Community Association Insurance Plan for residential risks, where the building sum insured is $50 million or less. Instead, CHU will substitute the existing general terrorism exclusion with an alternate one that only excludes the risks of biological, chemical or nuclear weapons, pollution or contamination resulting from such weapons.

The cover is only applicable to CHU Residential Strata Insurance Plans and Community Association Insurance Plans (residential risks), where the building sum insured is $50 million or less. Cover is not offered automatically for property outside the $50 million limit and it is not written as a sub-limit.[42]

CHU states that the decision to set the Building Sum Insured limit at $50 million was based predominantly on factors concerning affordability. They estimate that approximately 98 per cent of strata properties in Australia are insured for $50 million or less, with $50 million covering 99.7 per cent of the risks in their portfolio.

CHU believes that the cost of buying cover for the other 0.3 per cent of risks would make the overall price prohibitive for all policyholders. Further, they advise that while 'it is possible to investigate the purchase of this form of cover from overseas markets,

42 CHU Underwriting Agencies Pty Ltd, 'Terrorism Cover Fact Sheet', 28 February 2007, pp 2-3, http://www.chu.com.au/index.aspx?link_id=67.381.

[their] experience to date has demonstrated that the process is slow and the costs are very high'.[43]

In terms of other participants in the domestic terrorism insurance market, AIG has a reinsurance treaty in place to offer cover for residential high-rise buildings on a standalone basis, subject to aggregate limits.[44]

The issue of extending the scheme to include residential high-rise buildings needs to be considered in light of this market response and the desirability of its continued development.

CHU states in its *Terrorism Cover Fact Sheet* that its decision to offer terrorism insurance followed the 2006 review, which confirmed the exclusion of residential property from the scheme.[45] This is an important point, demonstrating that, although there is limited commercial terrorism insurance available for residential property in Australia, the 2006 decision was a factor in determining CHU's market response.

Stakeholder comments

Although there is no evidence that the exclusion of residential high-rise buildings from the scheme is having a negative economic impact, and the financial impact of extending the scheme to these buildings may be significant, some stakeholders have commented on the exclusion of residential high-rise buildings from the scheme.

Stakeholder views are focused on mixed-use high-rise buildings, particularly in central business districts. Particular views are that:

- the application of the scheme to mixed-use high-rise buildings should be reconsidered as they are:
  - becoming more prevalent, particularly in central business districts, with relatively few strictly commercial use building projects proceeding; and
  - perceived as higher risk than purely commercial use buildings located elsewhere;

43 CHU Underwriting Agencies, 'Terrorism Cover Fact Sheet', op cit, pp 3-4.

44 AIG also offers other terrorism insurance products. These include: property, terrorism and sabotage cover for material damage to building and contents, and business interruption losses following terrorism, sabotage, riot, strike or civil commotion and other events, which is available to Australian and overseas companies with physical assets and turnover to protect; and property terrorism cover for material damage and business interruption arising from a defined terrorist event, which is available to businesses with property in locations requiring terrorism cover or without a government facility or arrangement available to provide terrorism cover. Source: 'AIG People and Product Overview 08', pp 4, 9.

45 CHU Underwriting Agencies, 'Terrorism Cover Fact Sheet', op cit, p 1.

- consideration should be given to relaxing the 50:50 ratio of commercial to residential use in mixed-use high-rise buildings when determining whether the building is covered by an eligible insurance contract, and stakeholders should be consulted on the financial impact of any proposed change;

- many property trusts and commercial property investors have ownership interests in mixed-use high-rise buildings that consist of a commercial podium with commercial and residential space above, and on this basis the scheme should be extended by changing the ratio of commercial to residential use to 25:75; and

- consideration may need to be given to alternative methods for measuring the commercial and residential composition of high-rise buildings, for example, asset valuations or contributions to strata title levies.

Other stakeholders expressed concern about the exclusion of wholly residential high-rise buildings from the scheme. Particular views are that:

- given the importance of insurance for the purposes of investment in the property sector, the scheme should be extended to completed high-rise residential apartments as they are commonly dispersed within central business districts and may be targeted by terrorists;

- high-rise buildings that do not fall within the scheme and are not able to obtain terrorism insurance within Australia, obtain their cover overseas at considerable cost;

- owners of high-rise buildings that do not fall within the scheme but are able to obtain terrorism insurance within Australia, sometimes choose not to because of cost; and

- the scheme should be extended to both single and mixed-use high-rise buildings, where mixed-use buildings are not predominantly for commercial use, and any claims arising should be met from the existing pool, rather than a separate one.

Stakeholders' views on this issue are influenced by legal requirements which vary by jurisdiction for bodies corporate to obtain terrorism insurance. For example, Victorian law does not impose any requirement upon bodies corporate to obtain terrorism insurance. Consequently, the absence of commercially available terrorism insurances does not cause difficulties for Victorian bodies corporate of high-rise residential buildings in complying with Victorian insurance requirements.

Other views were that:

- although there is some concern about the exclusion of residential high-rise properties from the scheme, the absence of terrorism insurance for completed high-rise residential property has not prevented construction projects from proceeding;

- in a similar vein, while it is more difficult to obtain financing for commercial property compared to recent years because of the risk associated with commercial property development, the exclusion of residential high-rise buildings from the scheme is not a contributing factor; and

- apart from relaxing the arrangements for mixed-use high-rise buildings in central business districts, there are opportunities for the insurance market to provide coverage for other residential properties excluded from the scheme.

In response to these views, the underlying principles of the scheme continue to include the need to maintain, to the greatest extent possible, private sector provision of terrorism insurance, and to allow the re-emergence of commercial markets for terrorism risk cover.[46] Extending the scheme to residential high-rise buildings would run counter to these policy objectives, increasing its market coverage, thereby working against the intention that it operate on a temporary basis, and placing it in direct competition with commercial providers. Such competition could crowd out existing commercial providers and prevent or discourage new market entrants. This would, in turn, raise questions about the competitive neutrality of the scheme. Together, these developments would represent a fundamental shift in the policy rationale for the scheme.

It is also important to note that the scheme was not established to fill the market gap in domestically available terrorism insurance, but to alleviate problems faced by commercial property owners in obtaining finance where they were unable to obtain terrorism insurance, thereby protecting the wider Australian economy from the possible effects a downturn in the commercial property sector arising from the withdrawal of terrorism insurance. It was also established to protect the Australian financial system in the event of a terrorist incident resulting in large concentrated losses to one or more financial institutions.

The price of commercially available terrorism insurance and whether some residential high-rise property owners choose to purchase terrorism insurance from overseas markets are not necessarily issues for the scheme to address if they are not having a negative impact on the broader Australian economy or placing the Australian financial system at risk.

In light of the policy objectives of the scheme, the lack of evidence that the withdrawal of terrorism insurance is adversely affecting the availability of finance for the construction and purchase of units in residential buildings, and some re-emergence of commercial terrorism insurance for residential high-rise properties, this review does not support extending the scheme to include single use residential high-rise buildings.

46 Terrorism Insurance Bill 2002, Revised Explanatory Memorandum, 'Policy objective', pp 6-7.

However, extension of the scheme to mixed-use high-rise buildings that are not predominantly for commercial use could be examined in terms of the perceived anomaly between their exclusion from the scheme compared to similar buildings that are determined to be covered by an 'eligible insurance contract'. As previously noted, the policy and financial impacts of extending the scheme are potentially significant. This review will therefore recommend that the ARPC, in consultation with stakeholders and Treasury, examine the issue more closely having regard to the policy objectives of the scheme, and estimate the financial impact of extending the scheme through the collection and analysis of data.

Defence force and student accommodation

One group of stakeholders has requested that the issue of extending the scheme to include commercially developed and operated defence force and student accommodation be considered.

The issue relates to Public Private Partnerships where commercial property investors finance, construct, operate and maintain defence force and student accommodation. These property types fall within the scope of the scheme during the construction phase. However, as they are wholly for residential use, they are not covered by an 'eligible insurance contract' after completion. As such, the buildings are not covered by the scheme and owners must bear their own terrorism risk or seek commercial terrorism cover.

Although these properties are commercially operated, they are wholly for residential use on completion and, as such, are intended to be excluded from the scheme. Their exclusion from the scheme is also consistent with the exclusion of other commercially operated, wholly residential buildings. Extending the scheme to include them would require evidence that their exclusion is having a negative impact on the broader Australian economy or placing the Australian financial system at risk. That impact would need to be demonstrably greater than the impact of excluding other types of residential property. It would also require consideration of whether these properties are considered to be at greater risk of a terrorist incident than other residential properties.

Recommendation

That:

- the ARPC examine the effects of extending the scheme to mixed-use high-rise buildings that are not predominantly for commercial use, having regard to the need to maintain, to the greatest extent possible, private sector provision of terrorism insurance, and to allow the re-emergence of commercial markets for terrorism risk cover;

- the ARPC consult with relevant stakeholders to examine the issues, collect data and assess the impact of extending the scheme in this way, and have regard to:
  - the availability of commercial terrorism insurance for mixed-use high-rise buildings that are not covered by an 'eligible insurance contract';
  - an appropriate ratio of commercial to residential use in mixed-use high-rise buildings where residential use is greater than 50 per cent, subject to the availability and quality of data;
  - appropriate measures to determine or assist in determining the ratio of commercial to residential use in mixed-use high-rise buildings, for example, asset valuations or contributions to strata title levies; and
  - the risk profile of mixed-use high-rise buildings that are not predominantly for commercial use, including their location, concentration and proximity to buildings covered by an 'eligible insurance contract';
- in assessing the impact of extending the scheme to mixed-use high-rise buildings that are not predominantly for commercial use, the ARPC examine the likely impacts on policy holders' insurance premiums, the rate and structure of reinsurance premiums payable to the ARPC, insurers' retentions, the adequacy and structure of the reserve for claims, the ARPC's current and future retrocession purchases, the financial risk to the Commonwealth and consequently Australian taxpayers;
- the ARPC consult with Treasury throughout the process of examining this issue; and
- the ARPC report to the Minister with findings and recommendations by 30 September 2010.

Further, that defence force and student accommodation involving commercial property financing continue to be excluded from the scheme.

3.5 POSTCODE ALLOCATION

Issue

Whether to update the allocation of postcodes to tiers to ensure that all postcodes are allocated to the correct tier.

Background

The premiums charged by the ARPC for coverage under the terrorism insurance scheme fall within three tiers broadly representative of risk and are determined by ministerial direction. Current rates and tiers are set by the *Treasurer to Australian Reinsurance Pool Corporation (Premiums) Direction 2007*. The tiers are based on geographic location and are identified by postcode.

Table 3.5.1: Definition of tiers by geographic location

Tier	Geographic location[(a)]
Commercial property and business interruption	
Tier A	Central Business Districts of Australian cities with a population greater than 1 million (Sydney, Melbourne, Brisbane, Perth and Adelaide)
Tier B	Urban areas of Australian capital cities and cities with a population greater than 100,000 (Sydney, Melbourne, Brisbane, Perth, Adelaide, Gold Coast, Canberra, Newcastle, New South Wales Central Coast, Wollongong, Hobart, Geelong, Sunshine Coast, Townsville and Darwin)
Tier C	Areas not allocated to Tiers A or B, and any property not on mainland Australia or Tasmania but within the coastal sea of Australia
Public liability	
None	Not applicable (see discussion below)

(a) Insured property must be located on mainland Australia or within 12 nautical miles of the coast.

The original postcode allocation was done in 2003 by the National Centre for Social Applications of Geographic Information Systems (GISCA) at Adelaide University, in consultation with Treasury.

Discussion

The postcode list has remained largely static since it was created in 2003, apart from adjustments to account for new and expanded postcodes.

Under the Ministerial Direction on premiums, amendments can be made to the prescribed postcode list in order to account for new postcodes issued by Australia Post.[47] If an area covered by a Tier B or Tier C postcode is divided into two or more new postcodes, the new postcodes are treated as being covered under their original

47 *Treasurer to Australian Reinsurance Pool Corporation (Premiums) Direction 2007*, clause 4.

tier (Tier B or Tier C respectively). If an area covered by a Tier A or Tier B postcode expands and Australia Post issues a new postcode or changes the boundaries of an existing postcode to cover this additional area, the postcode covering this area is treated as a Tier B postcode.

The ARPC has made adjustments to the postcode list on a regular basis, consistent with the Ministerial Direction, and communicated these changes to insurers.[48] However, under the Ministerial Direction, there are limits to the changes that the ARPC can make, most particularly in relation to allocating postcodes to Tier A. Additionally, the changes the ARPC can make are incremental and only in reaction to changes made by Australia Post that fall within the circumstances specified in clause 4 of the Ministerial Direction.

As a result of the ARPC not having the power to holistically review the postcode allocation, demographic changes in the six years since the inception of the scheme may not have been fully captured by the ARPC's postcode allocation updates, and there may be some postcodes that are currently allocated to an incorrect tier, resulting in inequities in the scheme. For example, property owners (to whom insurers generally pass on the costs of reinsuring with the ARPC) in a postcode allocated to Tier A that should be in Tier B would be paying too high a premium. On the other hand, property owners in a Tier B postcode that would be more appropriately allocated to Tier A would be paying too low a premium, and would in effect be subsidised by other policyholders.

Recommendation

That:

- Treasury, with the assistance of an outside contractor, update the allocation of individual postcodes to particular tiers to ensure that all postcodes are allocated to the correct tier;

- as a part of this process, the ARPC model the impact of any reallocation of postcodes to different tiers and advise the Government of its findings; and

- there should be a sufficient transitional period to allow insurers and policyholders to adjust to any reallocation of postcodes.

48 Each year the ARPC reviews its list of postcodes to ensure it reflects any changes made by Australia Post. The ARPC also ensures that the list does not include any postcodes that solely represent post office boxes (as the listed address of insured property must be its street address, not its delivery address). Any changes the ARPC makes to its list are published in its quarterly newsletter and on its website.

CHAPTER 4: ARPC'S PERFORMANCE AND THE FINANCIAL STABILITY OF THE SCHEME

Issue

The ARPC is established under and has certain functions and powers specified in the *Terrorism Insurance Act 2003* (the Act). It is primarily responsible for the administration of Australia's terrorism insurance scheme and must meet obligations under the Act and in response to the Australian Government's Statement of Expectations for the ARPC.

Background

The Act

The ARPC is a statutory corporation established under Part 3 of the Act. Its functions are to provide insurance cover for eligible terrorism losses (whether by entering into contracts or by other means) and perform any other functions that are prescribed by the regulations.[1]

The ARPC has the power to do all things necessary or convenient to be done for or in connection with the performance of its functions. The Act specifies that the ARPC has the power to charge premiums in respect of contracts of insurance for which it is the insurer, and the power to charge fees for services that it provides in connection with the performance of its functions.[2] The ARPC may invest surplus money under Division 3 of Part 3 of the *Commonwealth Authorities and Companies Act 1997* (the CAC Act).[3]

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1 Section 10.

2 Section 11.

3 Section 34(2). Subsection 18(3) of the *Commonwealth Authorities and Companies Act 1997* specifies that an authority may invest surplus money: (a) on deposit with a bank; or (b) in securities of the Commonwealth or of a State or Territory; or (c) in securities guaranteed by the Commonwealth, a State or a Territory; or (d) in any other manner approved by the Finance Minister. Subsection 18(5) of the CAC Act defines 'surplus money' as money of the authority that is not immediately required for the purposes of the authority.

The ARPC may employ people for the performance of its functions and the exercise of its powers. It may also engage consultants on terms and conditions determined by the ARPC.[4]

The Minister may give written directions to the ARPC in relation to the performance of its functions and the exercise of its powers, including in relation to the paying and borrowing of money, and in relation to insurers' premiums and retentions.[5]

The ARPC has a Board consisting of a Chair and at least four but no more than six other members. Members are appointed by the Minister on a part-time basis for no more than four years.[6]

As a statutory authority, the ARPC is subject to the requirements of the CAC Act. As a result, Board members must comply with strict corporate governance obligations. Additionally, the Australian National Audit Office must audit the ARPC's annual accounts.

The ARPC has a Chief Executive who is appointed in writing by the Board on a full-time basis.[7] The duty of the Chief Executive is to manage the affairs of the ARPC subject to the directions of, and in accordance with, policies determined by the Board.[8]

The ARPC is not subject to income tax and the Commonwealth guarantees the payment of money payable by the ARPC.[9] Had commercial reinsurers not withdrawn from offering terrorism reinsurance in Australia, these provisions would have given the ARPC a competitive advantage. To ensure that these provisions do not give the ARPC a competitive advantage once a substantial number of commercial reinsurers re-enter the market, the Minister can direct the ARPC to pay an equivalent amount to the Commonwealth to address the advantage.[10]

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

Statement of Expectations

The Government's Statement of Expectations for the ARPC was provided on 3 May 2007. The Statement of Expectations sets out the roles and responsibilities of the

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4 Sections 32 and 33.
5 Section 38.
6 Sections 12 and 13.
7 Section 24.
8 Section 25.
9 Sections 35 and 36.
10 Section 38(3).

ARPC, the relationships of the Board and issues relating to the transparency, accountability and operation of the ARPC.

It provides that, in addition to its primary role of providing terrorism reinsurance, the ARPC should be in a position to advise the responsible Treasury minister of likely costs to the ARPC in the event of a declared terrorist incident. To this end, the ARPC should model different scenarios to estimate the potential exposure should a terrorist incident occur.

The ARPC should also keep abreast of key international developments, including other government-run schemes and the affordability and availability of commercial terrorism insurance. It should inform Treasury and the Government of any key developments in these areas.

The Statement of Expectations also requires, amongst other things, that:

- the ARPC should interact directly with its clients and seek to continue to educate all insurers covered by the Act, both in Australia and overseas, about its objectives and implications;
- the Board should evaluate its performance through annual self-assessments, and its Chair should meet with the responsible Treasury minister at least annually to discuss the Board's performance; and
- the financial management of the ARPC, as an agency prescribed under the CAC Act, should be in accordance with the relevant legislative requirements and the Finance Minister's Orders.

Statement of Intent

In its Statement of Intent of 24 July 2007, the ARPC notes that:

- each cedant provides the ARPC with an annual report summarising its exposures to building, contents and business interruption risks at postcode level, which allows the ARPC to analyse the distribution of exposure risk across Australia;
- it has undertaken considerable work towards developing loss estimation models that will enable it to estimate its potential exposure in the event of a declared terrorist incident;
- it seeks to keep abreast of key international developments and the Chief Executive is a member of the Advisory Board to the OECD Network on the Financial Management of Large-scale Catastrophes;
- it seeks to ensure that all issuers of eligible insurance contracts are aware of their exposure to eligible terrorism losses by virtue of the operation of the Act;

- the Board's performance is evaluated annually; and
- further to its responsibilities under the CAC Act, the ARPC reports annually to the responsible minister and hence to Parliament and the public.

Further information regarding the ARPC and its work, including the Government's Statement of Expectations for the ARPC and ARPC's Statement of Intent, may be obtained from the ARPC website at http://www.arpc.gov.au.

Discussion

ARPC's performance

The 2006 review found that the ARPC is efficient, prudent and well regarded by stakeholders. In the context of the 2009 review, stakeholder views regarding the ARPC's performance in administering the scheme have remained positive. Particular views are that:

- the scheme is stable, efficient and widely accepted by industry;
- the ARPC has been flexible in allowing some insurers to reinsure on a calendar, rather than financial year basis, and allowing others to join the scheme part way through the year;
- industry is supportive of the ARPC's purchase of retrocession, announced in February 2009, as a positive, cost-effective strategy that gives the scheme additional capacity of $2.3 billion in the event of a declared terrorist incident;
- the ARPC's current levels of data collection and analysis have supported the purchase of a satisfactory amount of retrocession at a reasonable price;
- the ARPC's risk modelling and loss estimation capabilities are highly regarded, both domestically and internationally;
- the ARPC has improved communication with, and guidance to, insurers to improve industry's understanding of issues such as eligibility for the scheme and uploading data to the Reinsurance Information System (RISe),[11] the ARPC's client information management system. RISe facilitates the submission of aggregate data reports by

11 In May 2007, ARPC partnered with the Axe Group to extend the functionality of its existing aggregate exposure information system, ARAS. The new system was named RISe. The purpose of the system is to streamline the management of client information into one system and provide one place for cedants to lodge their information within a secure and user-friendly environment. Further information may be obtained from the ARPC website at http://www.arpc.gov.au/_downloads/RISe_Cedant_User_Manual_V1.02.pdf.

insurers to the ARPC. It also allows the ARPC to quickly obtain various reports based on the large volume of data provided by insurers; and

- quarterly data collection processes are well understood and user-friendly.

Objective measures of the ARPC's performance include:

- considerable development of its loss estimation capabilities, including through key partnerships with Finity Consulting, Risk Frontiers, the Attorney-General's Department and Geoscience Australia (see below for details);
- the successful placement of a retrocession program, the financial stability of retrocessionaires and, in all cases but one, the right to terminate contracts with retrocessionaires if their credit rating is downgraded by more than one grade (see below for detail);
- continued growth of investments from the collection of premiums and investment income;
- a net expense ratio of 8.82 per cent in 2008-09 (forecast) which represents a significant increase on 2007-08 due to the expense of placing the retrocession program, but compares favourably to the industry average for reinsurers of 15 to 20 per cent; and
- historically, the gross expense ratio has varied between 3 and 5 per cent:
  - **2008-09** — 5.19 per cent with the increase on 2007-08 attributable to a full year of broker's fees and retrocession placement fee, an additional allocation of $100 million to fund managers, system support for RISe and the introduction of a treasury investment management system.
  - **2007-08** — 4.55 per cent with the increase on 2006-07 attributable to an increase in employee expenses principally represented by additional staff members; additional expenses relating to the possible placement of a retrocession program; and an increase in the depreciation and amortisation expense;
  - **2006-07** — 4.53 per cent with the increase on 2005-06 attributable to a reduction in the net premium revenue; an increase in employee expenses; additional expenses relating to the development of the loss exposure model and the expensing of deferred acquisition costs from 2005-06; and an increase in the depreciation and amortisation expense; and
  - **2005-06** — 3.87 per cent compared to 3.28 per cent in 2004-05.

Other measures of the ARPC's performance are in the areas of:

- **Awareness raising** — the ARPC has undertaken an awareness raising campaign to ensure that all insurers are aware of the scheme and their obligations under it and to offer reinsurance contracts to all those insurers who write eligible insurance contracts. The campaign includes initiating and maintaining contact with industry bodies and individual insurers and conducting a targeted advertising campaign both in Australia and overseas.

- **Financial management** — as part of its responsibility for the financial management of the scheme, including overseeing investment of the reinsurance premiums, the ARPC has entered into investment management agreements with two professional funds managers that provide for the investment of part of the pool fund in areas permitted by the CAC Act.

- **Cedant reviews** — the ARPC conducts a cedant review program to assist clients meet their obligations under the reinsurance agreement. The program involves direct discussion between the ARPC and its clients and therefore further enhances the ARPC's awareness campaign.

- **International engagement** — the ARPC also maintains regular contact with the global reinsurance market, including in the course of placing its retrocession program, through contact with overseas terrorism insurance schemes and via the Chief Executive's membership of the OECD's Network on the Financial Management of Large-scale Catastrophes.

Loss estimation

One of the key expectations of the Australian Government for the ARPC is for it to be in a position to advise the responsible Treasury minister of likely costs to the ARPC in the event of a declared terrorist incident.

The ARPC has developed its ability to estimate losses from a potential terrorist attack in two ways:

- the analysis of data provided to it by insurers through aggregate reporting arrangements; and

- the development of its loss estimation modelling capability.

Data analysis

The ARPC uses data collected from insurers who reinsure with the ARPC in its loss estimation modelling. Insurers are required, under their reinsurance agreement with the ARPC, to provide aggregated postcode level exposure data annually. This data separately identifies building, contents and business interruption risks, allowing the ARPC to analyse the distribution of risk across Australia.

Additionally, the ARPC obtains street level data on a voluntary basis from a small number of insurers with large exposures in Tier A locations. This has provided the ARPC with statistically significant exposure data. The ARPC has recently approached a small number of insurers, seeking updated street-level data, which will further enhance the reliability of its loss estimation modelling.

Data collected by the ARPC on an annual basis is shared with a number of specialist advisers (see next section on loss estimation modelling for a list of these advisers) for the purpose of enhancing its loss estimation capabilities. The data is de-identified and individual insurers cannot be identified by organisations other than the ARPC. The ARPC's data sharing arrangements are routinely communicated to insurers. Where the ARPC proposes to share data collected on a voluntary basis, it notifies insurers of its intentions.

Loss estimation modelling

Since 2003, the ARPC has also developed its loss estimation modelling capabilities in collaboration with a number of specialist advisers, including:

- Finity Consulting, an Australian general insurance actuarial consulting firm and the ARPC's actuary;
- Risk Frontiers, a commercial arm of Macquarie University that specialises in quantitative natural hazards risk assessment and risk management;
- the Australian Government Attorney-General's Department, which supports the Government in its national security and emergency management systems; and
- Geoscience Australia, which provides geoscientific information and knowledge to assist the Government and community to make informed decisions about the safety of critical infrastructure. Geoscience Australia also provides geoscientific information and knowledge to inform responses to rapid and slow onset hazards, and to inform the detection of change and emergency management.

One of ARPC's first priorities was to build a loss estimation model. The ARPC engaged Finity Consulting to investigate generic values and characteristics of CBD office blocks and develop a method of estimating losses from conventional terrorist attacks. The work was useful in the initial stages of the development of ARPC's loss estimation capabilities. However, significant additional work has been undertaken since that time and this model will not be developed further.

The ARPC progressed from the basic model to MapInfo, which was populated with street level data. However, as the ARPC undertakes further development work in conjunction with Risk Frontiers, the Attorney-General's Department and GeoScience

Australia, the MapInfo model will no longer be utilised in estimating the ARPC's potential losses.

During 2006-07, Risk Frontiers started work on enhancing the ARPC's loss estimation capabilities. The model incorporated the main characteristics of the MapInfo system and the ARPC's available exposure data. The work done by Risk Frontiers was verified for reasonableness by Finity Consulting and reviewed by the Australian Government Actuary.

The model's concept was to accurately position exposure information by street address onto the MapInfo foundation. Blast footprints for various sized bombs could then be overlaid to determine the affected buildings, sums insured and resultant loss from a known event. The model was also to have the ability to customise blast footprints to match actual damage reports.

Over the 2006-07 to 2008-09 period, development of the ARPC's loss estimation capabilities was achieved using a staged process:

- Stage 1 — incorporation of capability to estimate losses from conventional terrorist attacks in Sydney Tier A locations, completed June 2007;

- Stage 2 — incorporation of capability to estimate losses from conventional terrorist attacks in Melbourne, Brisbane, Adelaide and Perth Tier A locations, completed June 2008;

- Stage 3 — development of capability to estimate losses from biological and chemical terrorist incidents and business interruption losses.

The ARPC will continue to work with Risk Frontiers during 2009-10. It intends to incorporate the latest street address data and fully test the peak exposure report and functionality of the model, as requested by the retrocessionaires. It will also incorporate recommendations arising from the review undertaken by the Attorney-General's Department (see next paragraph).

In 2008, the ARPC also requested the Attorney-General's Department undertake a major review of its loss estimation model. The scope of the review was to provide an assessment of whether the ARPC's loss estimation modelling approach and capabilities were reasonable, and advise on possible improvements to the model.

The review recommended a three-year development program to improve ARPC's loss estimation capabilities. The development program is designed to enhance both the current model and develop a more rigorous underpinning model capacity as follows:

- Year 1 — enhancement of the ARPC's current loss estimation model through a range of measures, including further integration and categorisation of data, development of blast damage outcomes to loss translations and development of partial damage cost modules;

- Year 2 — development will focus on building the tools required to make operational the current Critical Infrastructure Protection Modelling and Analysis (CIPMA)[12] approach to inform the ARPC of probable losses immediately after an event. The program will also develop the framework for integrating data on the spread of a chemical or biological plume in CBD areas.

- Year 3 — development will focus on making the CIPMA loss model capability operational for blast as well as chemical and biological incidents.

The ARPC's approach to continuous improvement of its loss estimation capabilities has increased its ability to provide reliable advice to the Australian Government on the likely costs of a terrorist incident. Its loss estimation capabilities are highly regarded by insurers and reinsurers and widely considered to be at the forefront of international achievements in this area. The quality of the ARPC's loss estimation modelling was an important factor in the capacity and pricing it was able to obtain for its retrocession program.

Retrocession

The 2006 review gave the ARPC the discretion, once the pool had reached $300 million, to determine whether to use premiums to build the pool further, purchase reinsurance for the scheme or undertake a combination of the two. In 2008, the ARPC engaged the services of Guy Carpenter Ltd to investigate the availability of retrocession coverage for the pool, and to determine capacity and pricing. The ARPC found that that global capacity at a reasonable price was starting to re-emerge, particularly for national pooled arrangements.

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12 The CIPMA program is a key initiative in the Australian Government's efforts to enhance the protection of our critical infrastructure. CIPMA will examine the relationships and dependencies between critical infrastructure systems, and will demonstrate how a failure in one sector can affect the operations of critical infrastructure in other sectors. It will do this through a computer-based capability that uses data and information from a range of sources (including the owners and operators of critical infrastructure) to model and simulate the behaviour and dependency relationships of critical infrastructure systems. This information will assist the development and direction of Government policy in national security and critical infrastructure protection, and assist owners and operators to better protect their critical infrastructure. CIPMA is managed by the Attorney-General's Department. The Department works closely with the CSIRO and Geoscience Australia to build CIPMA's capability. Successful development of CIPMA relies on support from a range of stakeholders, including the owners and operators of critical infrastructure, State and Territory governments, and Australian Government agencies. Source: CIPMA Fact Sheet at Trusted Information Sharing Network website http://www.tisn.gov.au/.

As a result of these investigations, the ARPC decided to enter into a $2.3 billion retrocession program with over 40 reinsurers from the Australian, European, Lloyd's and Bermudan markets, with coverage commencing on 31 December 2008. The former Assistant Treasurer announced the successful placement on 11 February 2009.[13]

The retrocession was placed in excess of $300 million in three layers:

- layer 1: $300 million excess of $300 million;
- layer 2: $1.6 billion excess of $600 million; and
- layer 3: $400 million excess of $2.2 billion.

This structure optimised market capacity and therefore participation in the program.

The revised structure of the scheme, as augmented by the retrocession coverage, is detailed in Table 4.1.

Table 4.1: Structure of the scheme following 2009 retrocession placement

Layer	Element
Layer 1	Policyholders' liability for some risk through a possible excess or deductible
Layer 2	Retention of some risk by insurers, up to a maximum industry retention per incident of $100 million as of 1 July 2009
Layer 3	ARPC pool, deemed at $300 million
Layer 4	Retrocession layer 1: $300 million excess of $300 million
	Retrocession layer 2: $1.6 billion excess of $600 million
	Retrocession layer 3: $400 million excess of $2.2 billion
Layer 5[(a)]	Commonwealth Government indemnity for up to $10 billion, incepting at $2.6 billion of losses
Layer 6	Possible liability for some risk by policyholders through the operation of the reduction percentage or policy limits, for losses excess of $12.6 billion

(a) The line of credit facility formerly sat above the retrocession coverage and below the Commonwealth indemnity ($1 billion of which guaranteed the line of credit). The line of credit facility expired on 30 June 2009 and has not, as yet, been replaced. Whether or not the facility is replaced is a matter for consideration by this review (see Chapter 5), the Government and the ARPC.

The retrocession purchased mirrors the coverage mandated by the scheme; that is, it includes biological and chemical risk.

The wide spread of participants in the program reduces the risk to the ARPC in the event of default by any one of the participants. Additionally, program participants are subject to a minimum credit rating. A downgrade clause in the retrocession contract

13 The Hon Chris Bowen MP, Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, 'Australian Government's Risk Under The Terrorism Insurance Scheme Reduced Through Purchase Of Retrocession', media release no. 6, 11 February 2009.

gives the ARPC the right to reassess and replace any retrocessionaire that is downgraded below that minimum credit rating.

Guy Carpenter actively monitors the financial stability of the ARPC's retrocession counterparties and will advise the ARPC of any concerns. Together, these measures assist in protecting the financial stability of the retrocession program and therefore of the terrorism scheme overall.

The ARPC's purchase of retrocession has moved the Commonwealth further from the risk of losses under the scheme. Previously, the ARPC's $1 billion line of credit facility, guaranteed by the Commonwealth, attached once the reserve for claims ($457 million as at 30 June 2008) was exhausted, with the $9 billion Commonwealth indemnity sitting above the line of credit. With the retrocession in place, the Commonwealth will be exposed only if losses under the scheme reach much higher levels. For 2009, the Commonwealth is only exposed to losses above $2.6 billion. The ARPC's retrocession placement also lessens the risk that a reduction percentage will need to be declared in the event of a declared terrorist incident.

The retrocession program also has the benefit of encouraging the return of the commercial market for terrorism reinsurance for Australian risks. The ARPC intends to continue to encourage this trend through the continued purchase of retrocession for the scheme, subject to market capacity and pricing. As such, the amount of retrocession purchased may vary from year to year, which will subsequently impact on the point at which the Commonwealth, through the indemnity, is exposed to losses under the scheme.

Recommendation

That:

- the ARPC's performance over the 2006 to 2009 period, including in building the financial stability of the scheme through its management of the pool and purchase of retrocession, be noted; and

- the ARPC continue to develop its risk modelling and loss estimation capabilities to support the financial stability of the scheme.

APPENDIX A

SUMMARY OF RECOMMENDATIONS — 2006 REVIEW

The Terms of Reference for the 2006 review were narrow in scope and consultation was targeted due to the relatively short time that the scheme had been running.

The review considered refinements to the scheme and made only minor changes to its scope to rectify identified problems in the provision of cover to commercial insurance relating to some, but not all, public authorities. It concluded that high-rise residential property and discretionary mutual funds should not be included in the scheme.

The review also made recommendations with regard to encouraging commercial involvement in the scheme, specifically that:

- the Australian Reinsurance Pool Corporation (ARPC) should continue to collect premiums and that, once the pool reached $300 million, the ARPC should be able to use its discretion to build the pool further, purchase reinsurance for the scheme or undertake a combination of the two;
- insurer retentions under the scheme be increased in three increments with effect, respectively, from 1 July 2007, 1 July 2008 and 1 July 2009, as follows:

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

  and

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

The recommendations were accepted by the Government and implemented.

APPENDIX B

TERMS OF REFERENCE — 2009 REVIEW

Reporting to the Assistant Treasurer, the Hon Chris Bowen MP, by 30 June 2009, Treasury is to inquire into:

- the need for the *Terrorism Insurance Act 2003* (the Act) to continue in operation; and
- the effectiveness, efficiency and impact on competition of the terrorism insurance scheme (established by the TI Act) and its administration.

Any recommendations made by Treasury must be consistent with:

- the need to encourage 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;
- encouraging the re-emergence of the commercial market for terrorist risk cover; and
- global conditions.

In conducting the review, Treasury is to:

- seek submissions from, and if appropriate, consult further with, key stakeholders including property owners, financiers, insurers and the Australian Reinsurance Pool Corporation;
- identify a range of sustainable options, that are consistent with the principles noted above, to address any identified problem and recommend a preferred option for any such problem; and
- assess, to the extent practicable, the likely costs, benefits and risks imposed by each option on consumers, business, government and the community as a whole.

Appendix C

Consultation with stakeholders

As part of the review, Treasury sought submissions from key stakeholders, and in some cases consulted further with those stakeholders, including:

Private sector

AIG Australasia
Aon Australia
Aon Benfield
Australian Bankers' Association
Australian Reinsurance Pool Corporation
Hannover Rückversicherung AG
Insurance Council of Australia
Lloyd's Australia
National Insurance Brokers Association
General Reinsurance Australia Pty Ltd
Guy Carpenter and Company Australia
Munich Holdings of Australasia Pty Ltd
Property Council of Australia
Swiss Reinsurance Company Ltd
Willis Reinsurance Australia Limited

State/Territory government agencies

Department of Premier and Cabinet (NSW)
Department of Premier and Cabinet (Vic)
Department of the Premier and Cabinet (Qld)
Department of the Premier and Cabinet (WA)
Department of the Premier and Cabinet (SA)
Department of Premier and Cabinet (Tas)
Chief Minister's Department (ACT)
Department of the Chief Minister (NT)

Australian Government agencies

Australian Prudential Regulation Authority
Attorney-General's Department
Department of Finance and Deregulation
Department of Prime Minister and Cabinet

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