

Chapter 10

State Involvement in Provision of Terrorism Insurance

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Introduction

The events of 11 September 2001 in the United States created an unprecedented degree of focus by governments throughout the world on the problems of terrorism. As well as taking direct action intended to prevent terrorist activity, substantial consideration and resources have been given to ways in which resilience against the consequences of terrorist activity may be improved. This has included examination of how national and international financial systems may be made more robust. Given the important role insurance plays in helping to facilitate economic activity, it is unsurprising that the operation of national and international insurance markets have been prominent in these considerations.

In several countries this has given rise to new arrangements in which there is a partnership between the state and the private sector to enable terrorism insurance to continue to be offered on the scale required and at reasonable terms. Where existing arrangements were already in place, they have usually been reviewed, and in some cases updated, to ensure that they deal adequately with present circumstances.

This chapter looks at the issues which need to be considered in order to fully understand the working of terrorism insurance schemes that have been state sponsorship. It then goes on to describe the scheme that is operated in the United Kingdom by the Pool Reinsurance Company Limited (Pool Re) with reference to these issues and finally describes several other national schemes so that comparisons may be made.

Although the attacks in the United States changed perceptions of terrorism risk fundamentally, special arrangements to deal with terrorism insurance had existed in several countries prior to these events. Within Europe, a scheme has been in place in Spain for more than fifty years and France and the United Kingdom have also had legislation affecting the way in which terrorism insurance is provided. In South Africa, a specific scheme has been operating since 1979.

Such arrangements have usually been created in response to difficulties that were specific to the country in question, and naturally the provisions that have been put in place reflect both the nature of those local problems and the nature of local insurance markets.

Since September 2001, terrorism activity has been viewed in a more international context. However, solutions that have been developed still need to acknowledge the characteristics of local insurance markets and this has given rise to variations in approach. The result is that a comparison of schemes in different countries shows similarities but also differences. This could be surprising, if the rationale were not examined.

Scheme Comparison

In seeking to understand and compare the many schemes that now exist, a range of key features needs to be looked at. These include:

- How is an 'act of terrorism' defined?
- What is the extent of the cover provided and what exclusions apply?
- What provisions are there to safeguard the interests of the different stakeholders in the scheme?
- How do the arrangements address the question of participation and ensure adequate diversification?
- What financial structures have been adopted?

Definition of 'Act of Terrorism' in Terrorism Pools

Central to each scheme is the definition it adopts of what constitutes an act of terrorism for the purpose of the indemnity. The definition may be included in specific enabling or associated legislation or it may be drawn from the way terrorism is defined in the country's criminal code. Several examples of the definitions used appear later and it is worth comparing them as some differ less than may appear at first sight. It is important to note that when a scheme has been set up to provide reinsurance (as opposed to insurance) it may be the case that, as well as providing cover that is reinsured into the terrorism reinsurance scheme, primary insurers also provide cover for events that are outside the scope of the terrorism definition used in the scheme. For example, in the United Kingdom, insurers that are members of the Pool Reinsurance scheme provide the cover mandated under the scheme with the definition adopted in the scheme. However, it has become usual for the member to also provide insurance cover for acts that are akin to terrorism but fall outside the definition if the insurer, in conjunction with the reinsurance market, is content to do so. As a result, the cover available to the insured can be wider than that provided by Pool Re itself. When this happens, the real significance of the definition is that it determines whether the insurer can claim indemnity from Pool Re or instead from their commercially placed catastrophe reinsurance programmes, rather than whether or not the cover provided to the ultimate insured is restricted by the definition.

Scope of Terrorism Pools

Most schemes, although not all, are structured to provide terrorism reinsurance cover to insurers that operate in the market and thus enable those insurers to provide insurance to their clients for terrorism risks. The entity providing the reinsurance cover may be a state-owned company, the state itself, or a private company that has state guarantees or contracts.

The scope of classes of insurance, subject matter and cover provided, varies between the different schemes. For example, the arrangements in place in the United States under extension of the Terrorism Risk Insurance Act 2002 (TRIA) apply to a broad range of property and casualty classes. Others, including the French, German and UK schemes, concentrate upon commercial property and resultant business interruption, while the Austrian and Australian schemes have application to other classes such as liability or life cover.

Schemes may differ in the capacity that they can provide for individual risks. This is often a result of monetary limits, reflecting a 'cap' on the government guaranteed element. Most seek to provide full value cover but some limit amounts paid in particular circumstances. So, for example, the Australian and Netherlands schemes in which the government involvement is subject to monetary limit, contain specific provisions to pro-rate claim payments should this be necessary as a result of the scheme having inadequate financial resources, overall, to deal with the cost of claims presented to it. The TRIA scheme, which again sets a limit on government funding, also specifically addresses the possible situation in which the overall resources of the scheme prove inadequate. The French, Spanish and UK schemes do not contain a specific limit on government engagement and hence do not contain such provisions.

There are other variations in cover between schemes, even when the same classes of insurance are covered. The aim of many schemes is to enable the reinstatement of terrorism cover that would otherwise be excluded from standard policies and, where this is the case, the cover provided will be bound by the monetary limits, exclusions and other provisions within these underlying policies.

Most reinsurance-based schemes provide that the monetary limits that apply to the terrorism cover are the same as those appearing in the underlying policy. However, as mentioned previously, schemes that are subject to an overall cap may have provisions to pro-rate the claims actually paid if losses are in excess of the total scheme resources.

In some countries, such as the United Kingdom and France, wider cover is provided for terrorism losses than the cover provided within the conventional policies for non-terrorism events, notably with regard to contamination and nuclear related events.

Financial Structure of Terrorism Pools

It had been mentioned that some schemes are operated by government bodies, some by state-owned companies and some by privately owned companies. Those operated as private companies typically have been developed in collaboration between the relevant government agency and representative bodies from the insurance industry.

Nearly all such schemes aim to involve both government and the private sector in some element of risk sharing, although the balance varies. Usually, the financing of the schemes is achieved by way of a series of layers but not others and with their participation changing from layer to layer. For example, the French and German schemes have initial layers of risk participation by direct insurers, supplemented at higher level by programmes with the international reinsurance market and then government engagement in excess of those limits.

The UK scheme is similar, although it contains no specific requirement for commercial reinsurance involvement and any payments that may be made by the UK Government are subject to a repayment provision.

Stakeholder Interests and Motivation

When looking at any scheme, it is useful to consider the identity of the ultimate financial stakeholders and what roles they will play in different loss scenarios.

Scheme structures must reflect the intended balance of interest between insureds, insurers, government and others who may share in the risk, or have clear interest in the arrangements, such as those involved in distribution.

The main interest of the ultimate insured is the ability to buy cover of a breadth and size to deal with anticipated losses, at reasonable cost. Insurers have an interest in ensuring that while providing this cover to their customers, they do so in a way that does not inappropriately expose their balance sheets or lead to unreasonable operational concerns. Governments have an interest to ensure that economic development is not hampered by lack of insurance protection and in helping to promote financial resilience more generally.

However, other considerations arise. Insureds will wish to know that there will be a reasonable level of continuity in the availability of cover. There is little merit in arrangements that can be bought when risk levels are considered low but cease to be available whenever perception of risk increases. They will also be interested to ensure that premiums are an appropriate reflection of the actual cost of terrorism claims over time and that there is a reasonable level of equity in terms of premium contribution between different insureds. Also they have a legitimate interest in price stability. It can be argued that if premiums are to reflect the cost of terrorism losses over the long term, then premium levels should be relatively low, reflecting the total cost of terrorism damage compared with other causes of loss.

Insurers play a key role in the distribution of terrorism insurance and will wish to know that their contribution in this regard as well as the role they may play in risk transfer is fully recognised. While they may be content to accept limited amounts of terrorism risk for their own account, the inherent difficulties in predicting terrorism losses tend to limit the amount of risk that insurers can carry before reimbursement from other parties in the financial chain. Because of its deliberate nature and catastrophic potential, terrorism losses cannot be forecast in any way that is comparable with conventional catastrophes. The effect of terrorism risk within risk-based capital models can be onerous and its volatile nature can threaten shareholder return expectations.

Understandably, governments are keen to ensure that they participate only if there are overwhelming reasons why this risk should be borne by the general taxpayer and also that arrangements in which they are involved do not operate in a way that discourages the involvement of private sector insurers unnecessarily. The different structures and operating procedures adopted by the schemes can have a strong bearing on these issues.

The design of the schemes needs to recognise all of these interests and, if schemes are to be successful, they need to be structures in a way that encourages positively the involvement of each major stakeholder.

Questions of distribution and choice are also important. Effective operation requires adequate spread of risk. Where there is inadequate or patchy participation, the interests of the risk carriers, insurers, reinsurers and government, will become compromised. Effective product distribution is necessary to help avoid this. In order to achieve this spread of risk, certain schemes operate on a basis whereby the purchase of terrorism cover is compulsory or automatic. Indeed in some cases, legislation compels participation on the part of certain of the market participants.

When looking at the balance of interest between stakeholders, price setting is especially problematic. By the nature of terrorism, neither the frequency nor the cost of terrorism losses can be forecast accurately in advance. Hence pricing cannot be approached conventionally. Traditional methods of forecasting frequency and severity are not applicable. This must be acknowledged in the financial structure in order to achieve a position that allows equity between stakeholders.