



Australian Government  
The Treasury

**TSY/AU**

# Terrorism Insurance Act Review: 2018

12 December 2018

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# EXECUTIVE SUMMARY

The Australian Government established a terrorism insurance scheme (the scheme) on 1 July 2003 under *The Terrorism Insurance Act 2003* (the Act).

The scheme was designed following the terrorism events in the United States on September 11, 2001, as a temporary measure to alleviate a market failure and the wider economic impacts of global reinsurers refusing to underwrite loss or damage to commercial property due to terrorism.

The scheme is administered by the Australian Reinsurance Pool Corporation (ARPC), a public financial corporation operating with Government capital and backed by a \$10 billion Commonwealth guarantee. The Act is intended to be a temporary measure to allow the re-emergence of a private reinsurance market for terrorism risk.

The Minister responsible for the Act is required to prepare a report every three years reviewing whether the scheme should continue. Previous reviews in 2006, 2009, 2012 and 2015 recommended the Act remain in force.

This review recommends that the Act remain in force and that the scheme remain in place.

In the absence of the Act there would likely be a market failure in the terrorism insurance market with wider economic implications. The estimated global commercial market capacity available for Australian terrorism reinsurance is considered short of the level required to cover against large, but possible, terrorism incidents. Several reinsurers have indicated they would find it difficult to participate in the Australian terrorism insurance market without a mechanism like the ARPC. Treasury engaged Finity Consulting to inform the decision to continue the scheme (Annex A).

This review also considered the appropriate level of compensation the Government should receive from the ARPC for the financial benefits it provides—as the ARPC operates with the Government’s capital and backed by a \$10 billion Commonwealth guarantee. Informed by the Australian Government Actuary’s report (Annex B), this review recommends the ARPC pay the Government an additional temporary dividend of \$10 million a year in 2018-19, 2019-20 and 2020-21.

This review also found that the current scope of the scheme, the approach to declaring a terrorism incident and the pricing of the scheme continue to be appropriate.

The Terms of Reference for the current review were released on 30 April 2018 (Appendix A).

# CHAPTER 1: INTRODUCTION

## Rationale of the scheme

The terrorism events in the United States on September 11, 2001, caused massive losses to commercial property and corresponding insurance payouts. Following these events, global reinsurers refused to underwrite for loss or damage to commercial property caused by terrorist activity. In turn, when existing primary insurance policies expired and property owners sought to renew them, primary insurers explicitly excluded terrorism cover in those renewal policies. As a result, commercial property owners, including in Australia, were forced to assume the risk of loss or damage to their properties if there were a terrorist event.

The Australian Government decided to intervene in the Australian insurance market to protect the Australian economy from the potential flow-on effects of the global withdrawal of terrorism reinsurance. In particular, the Government was concerned that forcing property owners to assume their own risk for terrorism would lead to a reduction in financing and investment in the Australian property sector, including a substantial reduction in commercial building activity.

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

The Act is intended to be a temporary measure to allow the re-emergence of a private reinsurance market for terrorism risk. As such, it is subject to triennial reviews to determine whether there is a need for the scheme to continue.

## Operation and coverage

The Act operates by overriding terrorism exclusion clauses in eligible insurance contracts.<sup>1</sup> An eligible insurance contract is a contract that provides insurance coverage for:

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

Further, the Act defines 'eligible property' as the following property located in Australia:

- buildings (including fixtures) or other structures or works on, in or under land;
- tangible property that is located in, or on, such property; and
- property prescribed by regulation.<sup>3</sup>

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1 *Terrorism Insurance Act 2003* (Cth), s8(1).

2 *Terrorism Insurance Act 2003* (Cth), s7(1).

3 *Terrorism Insurance Act 2003* (Cth), s3(definition).

In practice, this means that insurers have an obligation to insure for the risk of terrorism, which encourages them to seek reinsurance. Reinsurance is available through the ARPC; insurers may choose to reinsure through the scheme, through the private reinsurance market, or retain the risk to their own balance sheet.

Schedule 1 of the Terrorism Insurance Regulations 2003 ('the Regulations') sets out a number of exclusions to the definition of an 'eligible insurance contract', including a contract for insurance that provides cover for destruction or damage to a 'mainly residential building'.<sup>4</sup> Accordingly, the Act primarily applies to commercial property, however, following a recommendation in the 2015 Triennial Review, the scheme was extended to insurance cover for mixed-use and high value buildings.<sup>5</sup>

Schedule 1 also provides that a contract of insurance to the extent that it provides cover for loss arising from computer crime is not an eligible insurance contract for the purpose of s7(2) of the Act.<sup>6</sup>

The scheme does not provide cover for personal injury or death caused by a terrorist incident.

## When can a claim on the scheme be made?

A claim on the scheme may be made for eligible terrorism losses arising from any declared terrorist incident covered by an eligible insurance contract where the insurer has a reinsurance agreement with the ARPC. The scheme will not be triggered unless the Minister who has administrative responsibility for the Act declares that a terrorist incident has occurred for the purpose of the Act.<sup>7</sup>

There has been one declared terrorist incident in the history of the scheme – the siege incident at the Lindt Café, Martin Place, Sydney in December 2014. The ARPC's claims system recorded 92 claims totalling \$2.3 million of insured claims from 20 insurers as a result of the Lindt Café siege. Treasury understands the insured losses were for minor property damage and business interruption. As such, there has been no call on the Commonwealth guarantee (outlined below) in the history of the scheme.

Further, claims may only be made for 'eligible terrorism losses'. 'Eligible terrorism losses' are losses or liabilities arising out of a declared terrorist incident that are not losses or liabilities arising from the hazardous properties (including radioactive, toxic or explosive properties) of nuclear fuel, nuclear material or nuclear waste.<sup>8</sup>

## How a claim is funded

In the event of a declared terrorist incident for the purposes of the Act, claims would progress along the following sequence (Figure 1.1):

1. Losses would be met first by industry up to the level of each insurer's retention; then
2. From the ARPC capital up to the value of the deductible on the retrocession cover; then

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4 *Terrorism Insurance Regulations 2003* (Cth), r 5.1.

5 The Australian Government the Treasury 2015, *Terrorism Insurance Act Review: 2015*, recommendation 9, page 25.

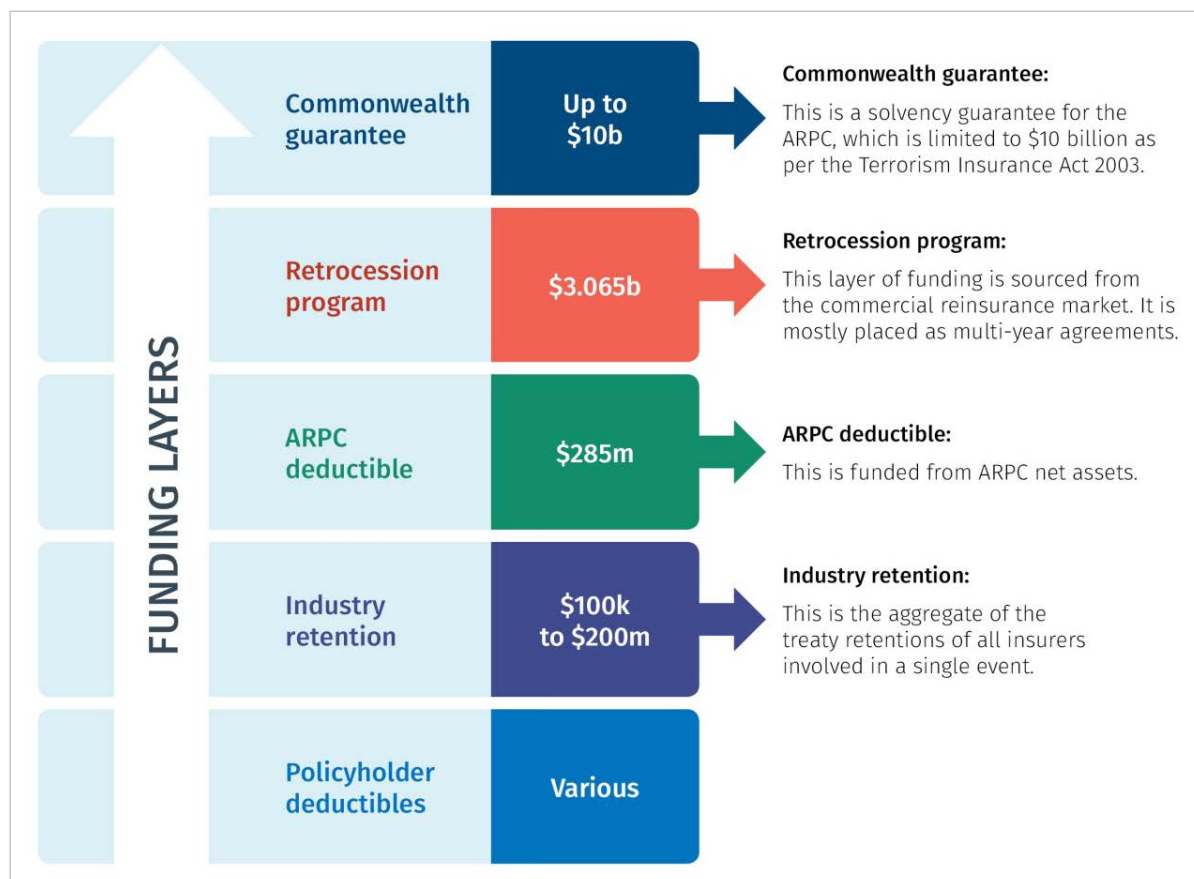
6 *Terrorism Insurance Regulations 2003* (Cth), r 5.32.

7 *Terrorism Insurance Act 2003* (Cth), s6.

8 *Terrorism Insurance Act 2003* (Cth), s3 (definition).

3. From the retrocession program (with any co-contribution being made from the ARPC capital and then through the Commonwealth guarantee); and finally
4. Through the Commonwealth guarantee, up to the \$10 billion cap.

**FIGURE 1.1: ARPC FUNDING LAYERS**



Source: ARPC

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

Insurers that reinsure their terrorism risks with the ARPC retain part of the cost from a terrorist incident. The retention, similar to an excess or deductible, requires the reinsurer to pay the first part of any claim. Retentions for individual insurers are calculated as 5 per cent of fire and industrial special risk premiums collected by the insurer, with a minimum retention of \$100,000 and a maximum retention of \$12.5 million.

The ARPC's reinsurance agreement also provides for a maximum industry wide retention of \$200 million. If the sum of the retentions of maximum individual insurers in respect of all eligible terrorism losses caused by a single terrorist incident exceeds the maximum industry wide retention of \$200 million, then each insurer's retention is reduced proportionately.

# CHAPTER 2: CONTINUATION OF THE ACT

## Issue

Whether there continues to be a need for the Act and whether market failure continues to exist.

## Recommendation

**Recommendation 1:** That the Act remains in force.

## Assessment

The current National Terrorism Threat Level in Australia is PROBABLE.<sup>9</sup> Individuals and groups continue to possess the intent and capability to conduct a terrorist attack in Australia. The elevated terrorist threat is likely to persist for the foreseeable future and it is not confined to any one city or metropolitan area.

Terrorists have plotted attacks in Australia. In July 2017, police and intelligence officials disrupted a plot to conduct a terrorist attack using an improvised explosive device against the aviation sector. A plot to develop an improvised chemical dispersion device was also disrupted.

This review finds that there would likely be market failure in the absence of the Act and that the Act should continue. While it is difficult to directly observe market failure given the presence of the ARPC and the \$10 billion Commonwealth guarantee, there are signposts pointing to likely market failure in their absence.<sup>10</sup>

There continues to be a shortage of capacity in the private market to provide terrorism insurance. Some capacity is available. The estimated global commercial market capacity available for Australian terrorism insurance is in the order of \$4 billion. This capacity is deployed into the Australian market predominantly through the ARPC's retrocession program.

However, this remains short of the level of cover required to protect against large, but possible, terrorism incidents. Modelling suggests that this level of commercial capacity is not sufficient to protect against a maximum single event loss from a conventional blast—an event which the Act was designed to protect against.

The estimated private sector capacity has fallen since 2015, from around \$5 billion (Chart 2.1). This was despite the state of the reinsurance market remaining broadly the same over the past three years. It was likely that the need in 2015 to clarify that biological and chemical attacks would be covered by the ARPC contributed to this contraction—as parts of the private sector have been reluctant or unable to match the depth and breadth of cover offered by the ARPC.

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9 Further information about Australia's National Terrorism Threat Level is available from [www.nationalsecurity.gov.au](http://www.nationalsecurity.gov.au).

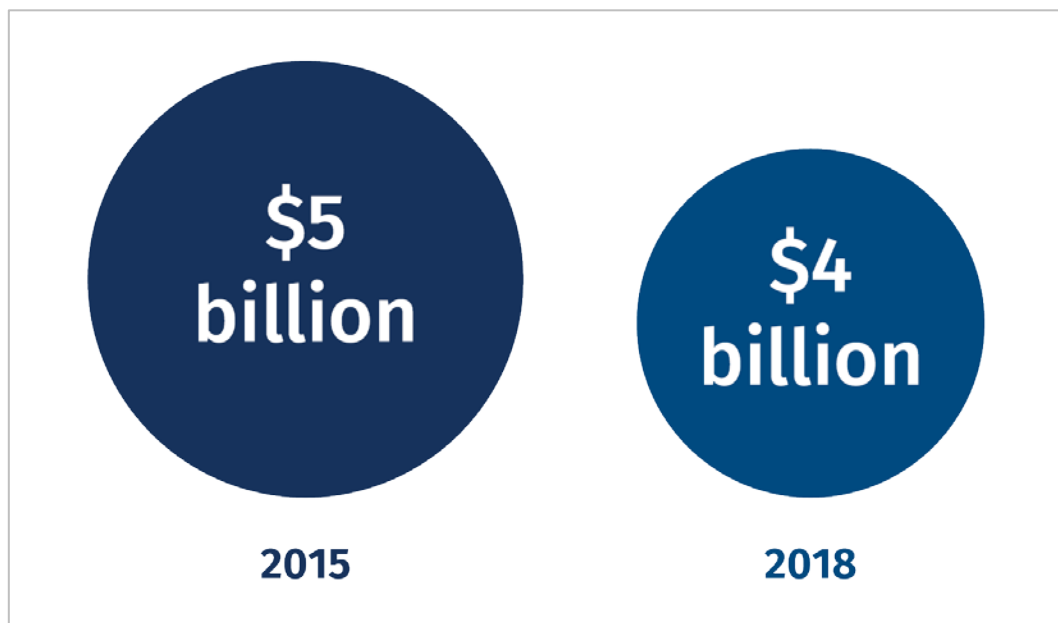
10 See further detail at Annex A.



Private sector capacity may likely fall further in the absence of the ARPC for the following reasons:

- Terrorism risk is not easily understood by the market. Terrorism incidents are not random events. The likelihood and scale of loss events depend on the activity of terrorist groups and government counter-terrorism capabilities. The Government has undertaken a series of initiatives, including *Australia's Strategy for Protecting Crowded Places from Terrorism*, to raise community awareness and protect lives.
- However, for the purposes of underwriting insurance products, there continues to be considerable uncertainty in determining what an actuarially sound price for terrorism risk would be. This is particularly since there has been a lack of depth in claims history.
- The ARPC has been in a position to help the market gain insight into exposure and risk through the security agencies. As a 'centre of expertise', the ARPC has helped global reinsurers make better informed decisions and encourage them to bring commercial capacity to the Australian market through the ARPC's retrocession program.
- Several reinsurers have indicated they would find it difficult to participate in the Australian terrorism insurance market without a mechanism like the ARPC. Some stakeholders were concerned that, while the largest insurers may be able to obtain reinsurance cover in the absence of the ARPC, most would not—or be only able to access limited cover that may not be cost effective.

**CHART 2.1: ESTIMATED GLOBAL CAPACITY FOR AUSTRALIAN TERRORISM INSURANCE**



Source: Finity

There do not appear at this stage to be viable alternatives to the ARPC for direct insurers to seek terrorism reinsurance cover. Most direct insurers obtain reinsurance cover from the ARPC to deliver direct commercial terrorism insurance cover to business policyholders. Direct insurers are not required to reinsure with the ARPC and may seek alternatives. Insurers periodically undertake reviews to test the market for alternatives to the ARPC, but there has been no indication that reasonable alternatives exist. Less than 1 per cent of risks are reinsured through arrangements outside of the ARPC.

Based on international comparisons, other jurisdictions continue to support terrorism pools or government-backed reinsurance schemes. There are around 20 foreign jurisdictions with terrorism pools or reinsurance schemes. Existing schemes that are subject to periodic reviews have been renewed. For example, the Terrorism Risk Insurance Act in the United States, which was set up in 2002 and is subject to periodic reauthorisation in order to continue, has been extended in 2005, 2007 and most recently in 2015 for six years. Instead of closing down, new schemes have been set up over the past decade in Belgium and Denmark.

Most stakeholders supported the continuation of the Act.

# CHAPTER 3: THE STRUCTURE OF THE SCHEME

## Issue

Whether:

- the level of payments to the Government related to fees for the Commonwealth guarantee and dividends as the scheme owner remain appropriate;
- the overall level of scheme pricing remains appropriate, including rewarding risk mitigation measures; and
- there should be a minimum threshold level of losses to eligible property before commencing the process to declare a terrorist incident.

## Recommendations

**Recommendation 2:** That the ARPC pays an additional temporary dividend of \$10 million a year for three years commencing in 2018-19 and terminating in 2020-21, with the Government to consider again the appropriate level of payments when this dividend ceases.

**Recommendation 3:** The current structure of pricing for the range of risks currently covered by the Act and the approach to declaring a terrorism incident remains appropriate.

## Assessment

### Compensation to Government

The ARPC currently makes two streams of payments to compensate the Government for the financial risk that it is exposed to in the event of a terrorism incident.<sup>11</sup> Since 2014-15, the ARPC has paid an ongoing guarantee fee fixed at \$55 million a year that reflected an assessment of the value of the guarantee at that time. Since 2015-16 the ARPC has also paid an ongoing capital holding fee of \$35 million a year. In addition to these ongoing payments, there were special distributions to the Government of \$57.5 million a year introduced in 2014-15, which terminated in 2017-18. Table 3 lists all of the ARPC's historical and proposed payments to the Government.

This review considers that the ARPC should pay an additional temporary dividend of \$10 million a year for three years—commencing in 2018-19 and terminating in 2020-21.

This review further recommends that the Government considers again in 2020-21 the appropriate level of payments made by the ARPC, when the \$10 million temporary dividend ceases.

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<sup>11</sup> Further details and the justification for these payments are outlined in the 2015 Triennial Review of the Terrorism Insurance Act, Budget Paper no. 2 of the 2014-15 Budget and Appendix A of the 2015-16 Mid-Year Economic and Fiscal Outlook.

The new \$10 million a year payment ensures the Government is appropriately compensated for the financial benefit it provides to the ARPC, while being prudent by allowing the ARPC to grow its net assets. Further, the three-year nature of this dividend strikes a balance between providing the Government with a predictable stream of payments while allowing the flexibility to review its appropriateness when the dividend ceases.

Two factors influenced the Government's decision to adjust the level of payments:<sup>12</sup>

- The appropriate price that the Government should charge the ARPC for providing it with a \$10 billion guarantee; and
- The level of net assets that the ARPC should retain to ensure it is run prudently.

**TABLE 3: ARPC'S HISTORICAL AND PROPOSED PAYMENTS TO THE GOVERNMENT (\$ mil.)**

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Guarantee fee	75.0	150.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0
Capital holding fee					35.0	35.0	35.0	35.0	35.0
Special distribution			57.5	57.5	57.5	57.5			
Special one-off dividend	100.0								
Proposed temporary dividend							10.0	10.0	10.0

Source: Various budget papers and the ARPC

### The price of the \$10 billion Commonwealth guarantee and the capital holding fee

In order to determine the price of the Commonwealth guarantee, one approach is to estimate the cost of obtaining equivalent reinsurance or retrocession cover from the private market. Given that the current guarantee fee is \$55 million for a \$10 billion Commonwealth guarantee, this is equivalent to the Government charging a rate of 0.55 per cent for the layer of reinsurance cover it provides to the ARPC. The Australian Government Actuary has provided one estimate of the cost of the Commonwealth guarantee worth \$140 million a year at market prices.

However, there are reasons why the Government charges the ARPC below commercial rates. As the owner of the ARPC, the Government retains any operating surplus and higher returns that accrue from charging a guarantee fee below the commercial rate. The Government also may choose to act as a benevolent insurer by charging a guarantee fee below implied market prices where there is a market failure.

To estimate a reasonable guarantee fee, the Australia Government Actuary modelled an extension of the commercial market for terrorism reinsurance using observable price data from the ARPC's retrocession program. This methodology produced an estimated guarantee fee of \$65 million, which is \$10 million higher than what is currently being paid.

For the reasons outlined in the Actuary's report, this review considers the capital holding fee of \$35 million a year to continue to be broadly reasonable.

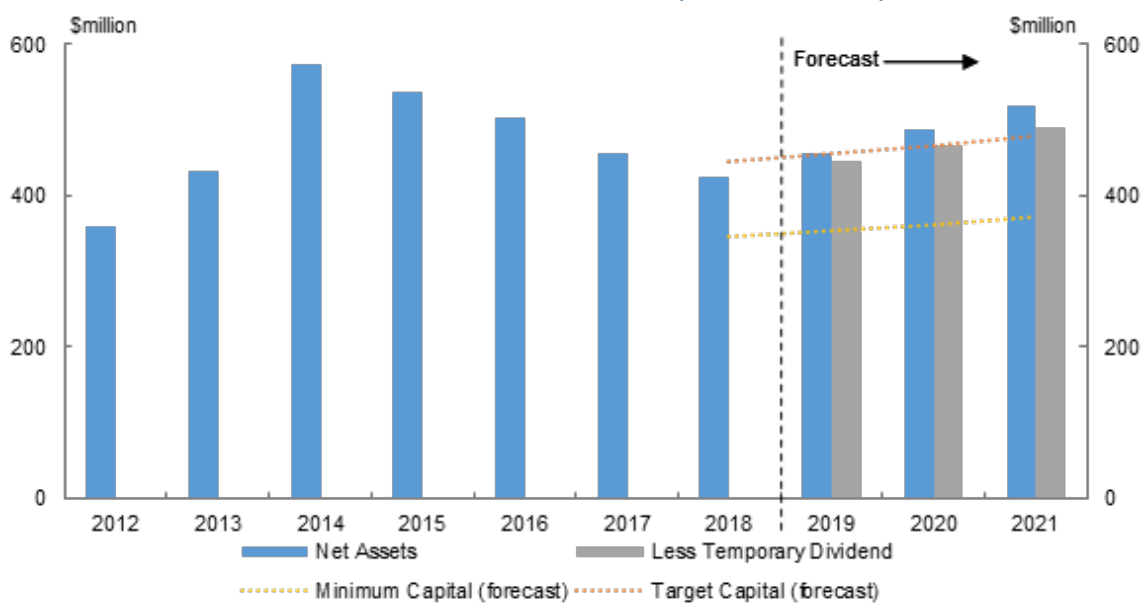
<sup>12</sup> For further detail on the assessment of appropriate payments to the Commonwealth see Annex B.

## Level of net assets

The ARPC's current level of net assets or capital has been between the minimum level and target level as outlined by the ARPC's capital management policy. The minimum level is the amount of capital required for the ARPC to respond to a single significant declared terrorism incident with claims of up to approximately \$3 billion but insufficient to purchase retrocession cover thereafter. The target level provides sufficient capital for the ARPC to meet its obligations in response to a single significant terrorism incident, as well as the ability to respond to retrocession market shocks or other shocks.

In order to protect the Government from undue financial risk in the event of a significant terrorism incident, this review considers that the ARPC should operate with capital comfortably in excess of the minimum level and that it is prudent to ensure there is a plan to build capital.

**CHART 3.1: ARPC NET ASSETS (AS AT 30 JUNE)**



Source: ARPC historical data and forecasts of the Australian Government Actuary and Treasury

Note: 'Minimum Capital' and 'Target Capital' are as forecast by the Australian Government Actuary. Minimum and target capital levels in the future would depend on a range of factors, including whether there are any changes to the ARPC's retrocession program.

The Australian Government Actuary estimates the ARPC to have net assets of more than \$30 million in excess of the forecast target capital level in 2020-21, factoring in existing payments to the Commonwealth (Chart 3.1).

Consistent with stakeholder feedback, the strengthening of the ARPC's balance sheet is expected to be underpinned by strong growth in premium income and a stable outlook for terrorism retrocession costs.

A few stakeholders were concerned about the level of the ARPC's payments to the Government in recent years. They preferred that some of these funds were redirected towards lowering premium costs, returned to clients or retained as capital in the scheme. This is consistent with the Government's position to not continue the \$57.5 million special distributions which terminated on 30 June 2018. With the temporary dividend, the ARPC would be paying \$100 million to the Government in 2018-19, compared to \$147.5 million in 2017-18.

Adjusting the ARPC’s payments to reflect the value of the Commonwealth guarantee is consistent with the policy intent of the Act. As noted in the explanatory memorandum at the time, those benefitting from the Commonwealth’s assistance should compensate the Government appropriately.

Further, under the current arrangements, the Government continues to act as a benevolent reinsurer to the sector. As stakeholders have indicated, policyholders benefit from broad terrorism insurance cover at a cost considerably lower than commercial rates.

**Premium Pricing**

Scheme pricing, or the rates that the ARPC charges its clients for the provision of terrorism reinsurance, are set and can be altered at any time by the responsible Minister. Currently, the ARPC charges insurers a percentage of the premium that they charge policyholders.

As outlined in Chapter 2, there is considerable difficulty in assessing terrorism risk on a contract-by-contract basis. In light of this, the scheme adopts a ‘community rating’ approach to pricing. Pricing varies depending on the postcode of the location of the insured property, with the ARPC publishing a list of postcodes divided into three tiers that vary according to population density:

- Tier A postcodes are central business district areas of cities with a population of over one million residents;
- Tier B postcodes are urban areas of all State capital cities and cities with a population of over 100,000 residents; and
- Tier C postcodes are those not allocated to Tier A or B.

Following the 2015 Triennial Review, the Government increased the premium rates that the ARPC charged, which became effective from 1 April 2016 (Table 3.2). This increase reflected the need to build the ARPC’s income and capital levels to cover expenses. Prior to this change, the premiums that the ARPC charged clients had not changed since the scheme began.

**TABLE 3.2: ARPC’S REINSURANCE PREMIUMS**

	<b>Tier A</b>	<b>Tier B</b>	<b>Tier C</b>
<b>Prior to 1 April 2016</b>	12%	4%	2%
<b>After 1 April 2016</b>	16%	5.3%	2.6%

Source: ARPC

Due to urbanisation and population movement, the list of postcodes used for the ARPC’s pricing is regularly reviewed as population statistics are updated and become available. The last change to the list occurred on 1 January 2018.

This review finds that the current pricing structure remains appropriate for the types of terrorism risks covered by the Act. While urban density is a rough proxy for terrorism risk exposure, the community-rating approach continues to be generally supported by the market as a suitable compromise. In particular, the threat is not confined to any one city or metropolitan area.

This review also finds the current level of premiums charged by the ARPC to be appropriate:

- The ARPC’s premium income arising from the current pricing structure is consistent with achieving its target capital. On current forecasts, it is expected that the ARPC will reach its target by 2020-21. Stakeholders have reported a positive outlook for growth in premiums charged by insurers.

- While the level of premiums collected means the ARPC's profitability has been significantly higher than commercial reinsurers, this is reasonable given the very rare instance of the ARPC having to pay claims.

Separate to this review, the Government will update the list of postcodes to reflect changes in population density.

Stakeholders broadly support the current community-rating premium structure. However, a number of stakeholders were concerned about the lack of price differentiation. They were concerned that high value properties that pay large commercial property insurance premiums would consequentially pay high terrorism insurance premiums—regardless of the level of terrorism risk faced.

## Risk Mitigation

This review considers that the ARPC's scheme pricing could not reliably be changed at this time to quantify the price impact of measures taken by policyholders to mitigate terrorism risk.

As some stakeholders noted, policyholders exposed to greater (or less) risk should ideally pay more (or less). In principle, there is also merit in premium prices accounting for policyholders that take measures which are effective in reducing the likelihood and size of future claims. However, this form of pricing depends on the ability to reliably quantify the price impact of any mitigation measures.

A fundamental element of underwriting insurance policies is to have an accurate assessment of risks and rating information. An inaccurate assessment of the risks could mean that the insurer's expected costs exceed premium income and hurt financial sustainability.

There is considerable risk that discounts would reduce the premiums paid, but not have a measurable or material impact on the likelihood or scale of a terrorism incident. This would reduce the premiums paid into the scheme—while risks would continue to be borne by the ARPC, reinsurers participating in the retrocession program and the Commonwealth as the reinsurer of last resort.

As outlined in Chapter 2 and in Finity and the Actuary's reports, there are inherent difficulties in quantifying terrorism risk for the purposes of pricing insurance products.

Many stakeholders found it difficult at this point in time to see how scheme pricing could reward the mitigation of terrorism risk appropriately. While mitigation measures are important, they were concerned it may be unclear as to whether they would be effective in reducing terrorism risk in real terms for insurance underwriting purposes.

When underwriting commonly insured risks, such as fire, insurers typically have access to a detailed widely-accepted set of standards on what 'effective' mitigation looks like. These allow for a well-informed and contestable assessment of the level of risk being underwritten. The National Construction Code, for example, has provisions for fire-safety for high rise buildings that specify amongst other things: smoke detection and warning systems; the number of fire-isolated exits per storey; sprinkler systems; measures to limit the spread of fire between storeys and buildings.

Stakeholders highlighted that, in the absence of detailed specifications of the suite of proportionate and effective measures required to harden a commercial building against terrorism incidents, it would be difficult to value and apply a discount for every commercial building covered. There were concerns that businesses would require a thorough on-site threat assessment by the relevant authorities or security professional, all of which would be onerous and costly, particularly for small- and medium-enterprises.

The Government, as part of *Australia's Strategy for Protecting Crowded Places from Terrorism*, provides overviews of mitigation for owners and operators responsible for the management of crowded places—including guidelines to tackle threats from hostile vehicle attacks, active armed offenders, improvised explosive devices and chemical attacks.

The ARPC has commenced work, drawing on relevant expertise, on developing tailored guidance for insurers and businesses on terrorism risk mitigation for the purposes of the Act. Future reviews could revisit the matter of the scheme better recognising mitigation following the completion of this work.

### **Threshold level of losses to eligible property**

This review finds the current structure of the scheme—with retained losses by policyholders and insurers and the scheme triggered by a declaration—is appropriate and well supported by the market. The Government needs to be able to provide timely confirmation that a terrorism incident has occurred to give the market and the wider community confidence that funding would be available to commence the process of rebuilding.

The Act currently allows for such a timely declaration. The Treasurer, in consultation with the Minister responsible for ASIO, is able to declare a terrorism incident for the purposes of triggering the scheme.

While a minimum loss threshold could potentially mean one less decision for the Government to consider in a time of crisis management, this review finds that the benefits of introducing a threshold are considerably outweighed by the potential disruption created and the likely impact on the market.

The process of quantifying and settling total losses from an insured event is not straightforward. It could take time—stretching for months and, in some cases, years (see Box 3.1).

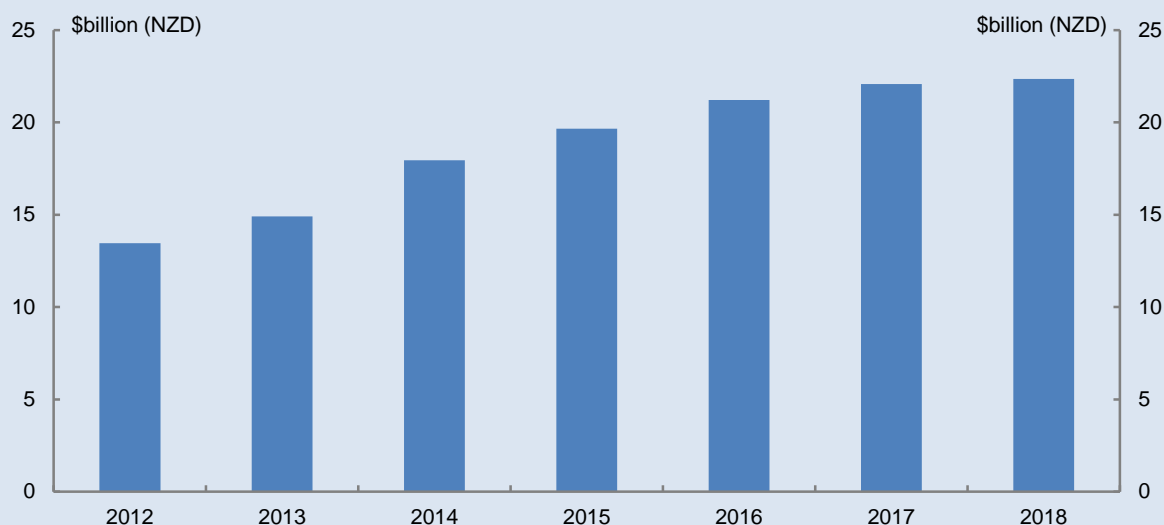


**BOX 3.1: LOSS CREEP — 2010-11 CANTERBURY EARTHQUAKES**

From September 2010 to the end of 2011, two major earthquakes—with a series of more moderate earthquakes and aftershocks—hit the Canterbury region of New Zealand (NZ). There were 185 fatalities and economic losses in the order of \$40 billion.<sup>13</sup>

The process of household and business policyholders settling claims with insurers has been long and drawn out. The estimated gross losses faced by the private insurance industry has risen with each passing year (Chart 3.2). It was estimated in 2012 that these losses were in the order of \$13 billion. This estimate has escalated to in excess of \$22 billion in 2018. This highlights the difficulties around agreeing on an estimate for the purposes of administering a minimum loss threshold.

**CHART 3.2: TOTAL ESTIMATED AMOUNT TO BE PAID OUT BY PRIVATE INSURERS FOR 2010-11 CANTERBURY EARTHQUAKES, BY YEAR OF ESTIMATE**



Source: Insurance Council of New Zealand data

There is the potential for a long tail of claims years after the event. There can also be long-running disputes over the validity of claims, whether a particular loss is covered and the contestability of the method of estimating industry-wide losses.

While not all large scale loss events drag out over the course of a decade, this review is concerned that requiring a minimum total loss threshold could lead to lengthy bureaucratic delays before the market and the wider community can have confidence that a terrorism incident has been declared and that claims covered by the Act can be made.

Further, stakeholders were concerned that in the current conditions, the introduction of a minimum loss threshold could lead to market disruption and create a gap in the terrorism insurance market. Direct insurers wanting retrocession cover below the loss threshold would be driven to seek it in the private sector independent of the ARPC regime. As one stakeholder stated, 'should threshold requirements obstruct or prevent a declaration being made in respect of an incident, this could void any commercial reinsurance recovery of an insurers' ARPC net retention.'

<sup>13</sup> Cowan H, Dunne B and Griffiths A, Earthquake Commission, 'Planning for Loss or Complexity? New Zealand's Earthquake Commission: The Story So Far' October 2016.

Stakeholders were also concerned there was insufficient capacity in the private market to fill the gap. Many considered that while the largest direct insurers may be able to negotiate retrocession cover (albeit at a higher price than that charged by the ARPC), smaller players in the market would find it difficult to get any cover at all.

A small number of stakeholders suggested a very low threshold (in the order of \$5 million) would mean less complexity—as it would be clear that terrorist incidents involving small financial losses would not trigger a claim. The Government does not support this. The Government should continue to have the flexibility to trigger the scheme to protect policyholders—regardless of the size of the financial loss. For example, such a threshold would have prevented the Government from triggering the scheme in response to the Lindt Café siege.

# CHAPTER 4: RECENTLY EMERGING ISSUES

## Cyber terrorism causing damage to property

### Issue

Whether cyber terrorism causing damage to property should be included in the scheme.

### Finding

**Finding 1:** Cyber terrorism is an emerging risk and there is yet to be a clear and evident market failure in relation to physical property damage from cyber terrorism requiring government intervention through the Act at this time.

### Assessment

The Australian Cyber Security Centre considers that the current risk of terrorist groups using a cyber-attack to impact Australia's interests and security is low.<sup>14</sup> Terrorist groups' use of offensive cyber capabilities to date have been limited. Terrorist groups lack the technical sophistication to threaten Australia's security using cyber means at this time. For now, terrorist groups are likely to continue to use basic methods, such as defacing websites and hacking social media accounts.

As a general principle, governments should consider intervening in the insurance market only where there is clear and demonstrated market failure.

This is consistent with the policy intent of the Act, which was to correct a market failure following global reinsurers withdrawing coverage for commercial property damage in the wake of the events of September 11, 2001. At the time, the inability of portfolio managers and building owners to obtain cover for high value properties because of terrorism, threatened to constrain the development of commercial buildings and infrastructure and was affecting investment and portfolio allocation decisions.

While it is early days, this review considers that the threat of cyber terrorism causing property damage is not yet clear or evident.

Given the risk of this kind of incident is low, and the lack of a history of such incidents, it would be difficult to predict how the market would react in the event of such a terrorist attack.

However, how the insurance market has responded to the growing risk of cyber incidents has provided some early signposts as to whether the market is functioning. As *Australia's Cyber Security Strategy* notes, businesses have become targets for malicious activity as they have connected online in increasing numbers. Malicious actors have been persistent in seeking to compromise Australian networks and are constantly improving their tradecraft.

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14 Australia Cyber Security Centre, '2017 Threat Report', p. 52.

Instead of retreating in response to the significant number of recent cyber incidents, a cyber insurance market has rapidly emerged. Cyber insurance has been the fastest growing sector of the Australian commercial insurance market, with coverage increasingly incorporated into business insurance packages or sold as an individual product.<sup>15</sup> As Australian businesses have become more aware of the threat, there has been a surge in demand from some businesses for measures to manage that risk, albeit from a low base (Figure 4.1).

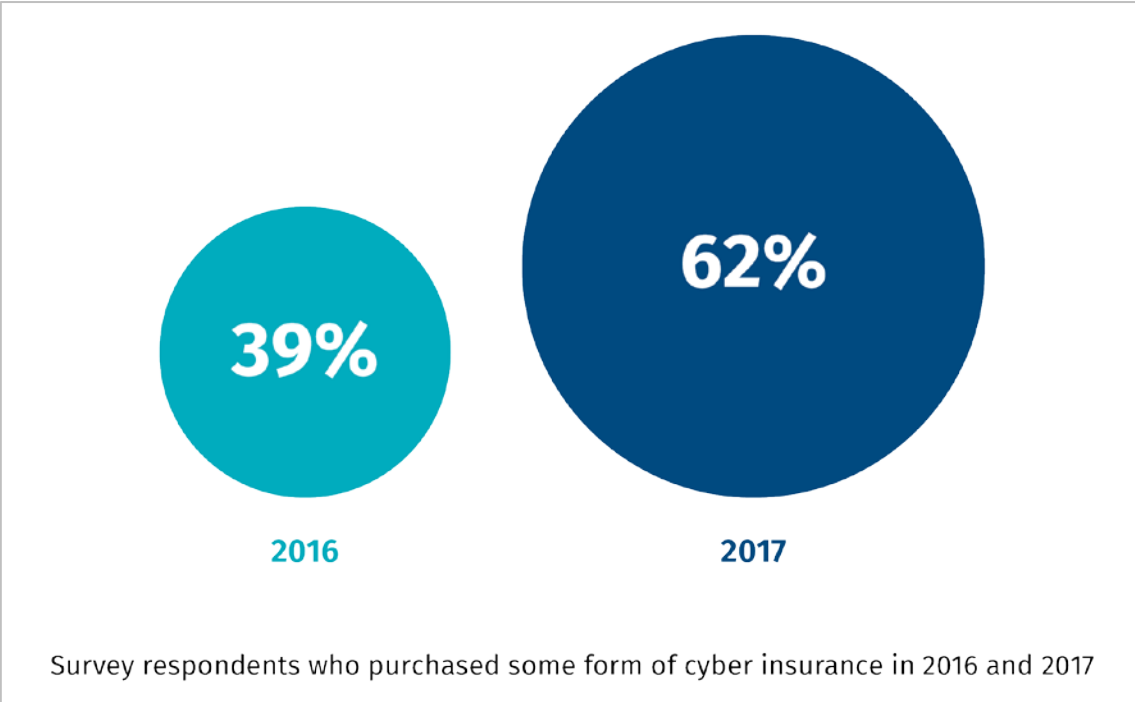
As understanding of new risks have increased, the insurance market has developed coverage solutions. Capacity to underwrite risk has followed. Insurance cover for cyber risk is becoming increasingly available. Alongside better cyber security practices, insurance is becoming part of a wider toolkit of risk reduction measures for many businesses.

However, cyber insurance is not a panacea. Since the cyber insurance market is still nascent, it is not uncommon for there to be gaps. New risks not previously contemplated can fall between existing classes of commercial insurance products. But the industry has been proactive in seeking to underwrite the risk and exploring how it could fill market gaps. Stakeholders noted a number of insurers have commenced exploring coverage options for physical damage as an extension to a standard cyber policy. The insurance market should be given the opportunity to develop solutions.

Nevertheless, as one stakeholder articulated, a market gap is not the same as a market failure, with only the latter requiring government intervention.

The Government will continue to monitor developments in the cyber insurance market and the evolving cyber security environment. There is potential for terrorist groups to develop capabilities in the longer term.<sup>16</sup>

**FIGURE 4.1: UPTAKE OF CYBER INSURANCE POLICIES HAS GROWN**



Source: MinterEllison, ‘Perspectives on cyber risk’, 2018. Survey respondents were ‘more than 70 representatives of ASX 200 and private companies, government agencies and not-for-profit organisations’.

15 PwC, ‘Insurance facts and figures’, Australia, 2017.  
16 Australia Cyber Security Centre, ‘2017 Threat Report’, p. 52.

While some stakeholders, including those representing business policyholders, supported the inclusion of cyber terrorism causing physical damage, others highlighted a number of concerns in addition to those already outlined above.

There are practical difficulties with providing cyber cover through the scheme purely for ‘terrorism’. Stakeholders noted that it is most likely that cyber incidents will be malicious rather than terrorism. As incidents tend to emanate from overseas, the culprits and their intent could be difficult to determine. If the scheme were to be extended to cover cyber terrorism, this could lead to uncertainty as to whether the ARPC would be liable in the event of an attack. The ARPC would be under pressure to respond even when it may not be a terrorism incident.

Extending the scheme to include cyber terrorism risks also has the potential to adversely impact the commercial insurance market.

As noted in Chapter 2, when the scope of risks covered by the ARPC were expanded in 2015 to cover chemical and biological attacks, private sector capacity for Australian terrorism insurance contracted significantly. As Finity’s report concluded, expanding cover to cyber risks would similarly further restrict commercial capacity, including for reinsurance. Stakeholder feedback supported this observation. While some reinsurance capacity would be available if there were sufficient underwriting information, some reinsurers indicated a reluctance to provide cover for cyber risk at all—particularly given the potential for catastrophic losses. One large reinsurer indicated it would not be inclined to provide cover for cyber losses arising from business interruption.

Cyber insurers have indicated they may be crowded out if the scheme were broadened, as they would not be able to compete against a government-backed scheme. One stakeholder noted that if the scheme were extended to provide cover only for property damage from cyber terrorism, and the direct insurer does not already provide cover for all losses arising from a cyber incident (‘all risks’), the direct insurer would be under pressure to offer the ‘all risks’ part of the cover—even if they do not have the capacity to do so.

Some stakeholders noted that the ARPC’s current premium structure, which is community rated based on postcodes and urban density, may no longer be appropriate if the scheme were broadened to cover cyber events. This is because exposure to cyber terrorism losses would not be concentrated in any one city or metropolitan area.

## Terrorist incidents causing harm to people

### Issue

The extent to which existing compensation and insurance coverage is available for terrorist incidents causing harm to people in Australia, including through armed assault.

### Finding

**Finding 2:** Coverage is broad for domestic terrorism incidents causing death or serious injury to Australians. There is an array of government schemes under which they could claim some form of compensation or funding, depending on their circumstances. There are also widely available insurance products that do not contain exclusions for terrorism incidents.

### Assessment

The Terms of Reference asked the factual question of the extent to which existing compensation and insurance coverage is available for terrorist incidents causing harm to people in Australia, in light of concerns personal harm is not being covered by the Act.

This review undertook consultation and a desktop assessment of the current system and found the level of coverage available to Australians to be broad.

If an Australian were killed or seriously injured in a terrorism incident in Australia, there is an array of government schemes under which they could seek to claim some form of compensation, government funding or assistance.

Commercial insurance products, with no specific exclusion for terrorism incidents, are also widely available.

Table 4.1 outlines a non-exhaustive list of government schemes and commercial products this review explored and illustrates the breadth of coverage available. Further discussion of each scheme or product is at Annex C.

**TABLE 4.1: RELEVANT GOVERNMENT SCHEMES AND COMMERCIAL PRODUCTS**

Government schemes	Commercial products
Workers' compensation	Private health insurance
Victims of crime assistance schemes	Public liability insurance
Compulsory third party insurance (CTP)	Group life insurance
The National Injury Insurance Scheme (NIIS)	
The National Disability Insurance Scheme (NDIS)	

However, the array of schemes and products creates significant complexity, and may make it difficult for an individual to understand what they may be entitled to. There are marked differences between State and Territory government schemes in the level of cover that can be claimed and the availability of coverage. Although widely available, commercial insurance products contain a myriad of conditions and exclusions. The cover available to an individual ultimately hinges on their specific situation and the circumstances around which the terrorism incident took place.

Nevertheless, there are life insurance and related products available in the market that provide cover for terrorist incidents causing death or serious personal harm, if individuals are inclined to seek it. This would support the proposition that this market is functioning.

### Government schemes

This review found that there is a wide range of cover for personal injury caused by acts of terrorism available under government schemes. In many cases, the fact that cover extends to injuries caused by terrorist incidents is non-controversial. A number of schemes have specifically addressed the issue of whether terrorism will be covered. For example, workers' compensation schemes in all States and Territories have arrangements for work-related injuries arising out of acts of terrorism to be covered.

Alongside workers' compensation, Victims of Crime Compensation is broadly available to primary victims of terrorism in all States and Territories. However, the amounts of compensation available differ between jurisdictions. In a number of jurisdictions, the amount of compensation could be reduced or limited if the victim is eligible for compensation under another scheme.

Further, Western Australia and Victoria allow claims under the compulsory third party insurance scheme for personal harm caused directly by the driving of a motor vehicle in an act of terrorism. Victoria, ACT and South Australia allow catastrophically injured persons to claim on the National Injury Insurance Scheme (NIIS) if they sustain an injury in a motor vehicle-perpetrated terrorist act. All jurisdictions except Tasmania and Western Australia allow persons who suffer a work-related catastrophic injury arising from an act of terrorism to claim on the NIIS.

A number of industry stakeholders were concerned that, because the availability and level of cover that can be claimed varies significantly between jurisdictions, businesses operating across multiple jurisdictions face a high degree of complexity. Some stakeholders considered there was scope to harmonise coverage. These matters are beyond the scope of this review.

### Commercial insurance products

Insurance cover for personal harm sustained as a result of a terrorist incident is available in the private market.

This review considered the extent to which private health insurance, public liability insurance and group life insurance covers individuals injured or killed in a terrorist incident.

Whether terrorism is covered under private health and public liability insurance is not controversial. Private health insurance policies generally do not exclude cover for medical treatment because the event giving rise to the claim is a terrorist incident. The Act allows claims to be made on public liability insurance policies for personal injury, provided a terrorist incident is declared under the Act and the insured incurs a liability in connection with the declared terrorism incident.

Australians predominantly access life insurance through superannuation, while a smaller number have bought life insurance directly or through a financial adviser. Because of the large number of individuals who access life insurance through superannuation, this review considered the extent to which group life insurance covered personal harm arising from a terrorism incident. Of the life insurance policies purchased in Australia, the vast majority are group life insurance. In 2015, there were 14 million group life insurance policies, compared to 4 million retail policies, and 3.9 million direct policies.<sup>17</sup> The Productivity Commission estimates this equates to around 12 million individuals in Australia with some type of insurance in their superannuation.<sup>18</sup>

17 ASIC, Report 498, *Life insurance claims: An industry review*, October 2016, p 35.

18 Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness*, April 2018, p 316.

This review undertook a desktop survey of the group life insurance guides for the largest superannuation funds in Australia (Table C.6 at Annex C refers). None of these group life products surveyed have a specific exclusion for death, disability or injury caused by a terrorist incident.<sup>19</sup>

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19 As outlined in Annex C, many group life insurance products surveyed contain exclusions from claims arising for war or warlike activity on a small number of death/TPD policies and on income protection policies. It is not possible to generalise so that an act of terrorism will be excluded because of an exclusion for war or warlike activity. Some policies have no exclusions at all for war or warlike activity. There have been reports that suggest it has been doubtful whether war exclusions have been relied upon after a terrorist incident (see for example Fullagar C, 'War and terrorism exclusion clauses', *Money Management*, 23 October 2015).



# APPENDIX A: TERMS OF REFERENCE FOR THE 2018 REVIEW OF THE ACT

## Regular enquiries

Treasury will report to the Minister on the following issues that are reviewed every three years:

- whether there continues to be market failure in the private sector supply of terrorism insurance, and consequently whether there is a need for the Act to continue;
- whether scheme pricing could be enhanced to recognise and reward risk mitigation;
- whether there should be a threshold level of losses to eligible property before commencing the process to declare a terrorist incident for the purposes of the TI Act;
- whether the strategic settings for the scheme design remain appropriate including:
  - the appropriate level of payments to Government for fees for the Commonwealth guarantee and dividends to Government as the scheme owner;
  - the appropriate level of net assets to be retained by the ARPC to pay first losses and the retrocession reinsurance deductible; and
  - whether the overall level of scheme pricing remains appropriate.
- any other matters that Treasury consider of importance to the operation of the scheme.

## Recently emerging issues

Treasury will report on the following recently emerging issues:

- whether the risk of cyber terrorism causing physical property damage should be included in the scheme by removing the scheme regulations exclusion for computer crime and over-riding policy exclusions for cyber terrorism; and
- the extent of coverage available for terrorism incidents causing harm to people including armed assault.

# ANNEX A: FINITY REPORT

# 2018 Review of Terrorism Insurance The Treasury

Date: July 2018



9 July 2018

The Treasury  
Financial System Division  
Langton Crescent  
Parkes ACT 2600

Dear Sir/Madam

## 2018 Review of Terrorism Insurance

We are pleased to provide Finity Consulting Pty Ltd's assessment of the market for terrorism insurance, as requested by Treasury as input to Treasury's triennial review of the Terrorism Insurance Act 2003.

Please do not hesitate to contact us if there are any questions.

Yours sincerely

A handwritten signature in black ink, appearing to read "Stephen Lee".

Stephen Lee

A handwritten signature in black ink, appearing to read "Geoff Atkins".

Geoff Atkins

**Fellows of the Institute of Actuaries of Australia**

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# 2018 Review of Terrorism Insurance

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## Part I Executive Summary

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The Treasury has engaged Finity Consulting Pty Limited (“Finity”) to assess whether there continues to be a market failure in the private sector supply of terrorism insurance, and consequently whether there is a need for the Terrorism Insurance Act 2003 (“The Act”) to continue.

It is our opinion that there is a need for the Act to continue currently and into the foreseeable future. Our assessment is based on the following:

- There is insufficient global insurance market capacity to adequately cover Australian commercial properties without an industry pool arrangement like ARPC. That is, there continues to be market failure.
- There is general consensus among insurance industry stakeholders that there are limited alternatives to ARPC for buildings in dense areas or that are considered high risk.
- Global terrorism insurance pool experience suggests that there is a general need for industry wide pools to protect against the risk of terrorism.

We also note that the Act provides outcomes that we would consider to be favourable from the perspective of risk protection against terrorism, such as the following:

- Certainty to policyholders around getting coverage, the terms of the cover, and the amount of cover.
- A solution to this market failure while also facilitating meaningful transfer of risk from the Commonwealth to the global insurance markets through retrocession.
- Resilience to continue to provide cover even after a large loss.
- Research and analysis of exposure and risk.

The design of ARPC has held up well since its inception in 2003. A recent study by CASS Business School endorsed ARPC’s role in removing and redistributing risk, with triennial reviews to ensure that it continues to evolve in consultation with its stakeholders in government and industry, and the wider needs of Australian society. Finity considers these to be positive features of the Act.

## Part II Detailed Findings

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### 1 Introduction

#### 1.1 Purpose and scope

The Treasury has engaged Finity Consulting Pty Limited (“Finity”) to assess whether there continues to be a market failure in the private sector supply of terrorism insurance, and consequently whether there is a need for the Terrorism Insurance Act 2003 (“The Act”) to continue. The Act<sup>1</sup> requires that “*at least once every 3 years after the startup time, the Minister must prepare a report that reviews the need for this Act to continue in operation.*”

Treasury has requested Finity to opine on the following two areas to assist its preparation of its review:

- (a) Whether market failure exists, and consequently,
- (b) Whether there is a need for the Act to continue.

To assess this, we will consider the extent of market failure that continues to exist, if any, and any specific areas particularly affected by market failure. An alternative way of thinking about this is to ask what gaps might exist if the Act was discontinued.

The continuing need for the Act will need to consider the extent to which market failure persists, what would occur if terrorism risk was entirely privatised, and the consequences of government intervention through ARPC.

#### 1.2 General approach

Our general approach can be described as follows:

1. Undertake a desktop review of available terrorism insurance products in Australia and internationally.
2. Conduct interviews with major Australian reinsurers and reinsurance brokers to survey the available level of global reinsurance capacity and capacity available to Australia.
3. Conduct interviews with commercial property insurers and underwriting agencies to ascertain the availability of terrorism insurance. We will seek to understand impediments, if any, to insurers providing terrorism insurance as well as underwriting considerations when deciding on risks to accept (e.g. any restrictions on location etc.).
4. Based on our engagement with stakeholders, we will opine on whether commercial market solutions could reasonably be expected to address market failure that initially necessitated the Act. We will consider other relevant factors affecting the continued need for the Act.

---

<sup>1</sup> Section 41



### 1.3 Structure of this report

The rest of this report is structured as follows:

- Section 2: Overview of ARPC and the insurance industry
- Section 3: Assessment of continuing market failure
- Section 4: Other factors affecting the need for the Act to continue
- Section 5: Global comparisons
- Section 6: Summary of our conclusions
- Section 7: Reliances and limitations to this report

The appendices to this report provide additional detail for the reader.

## 2 Overview of ARPC and the insurance industry

### 2.1 Reason for the Terrorism Insurance Act 2003

The Terrorism Insurance Act 2003 (“The Act”) was necessitated following the 11 September 2001 terror attacks. This resulted in commercial property insurers withdrawing terrorism cover for their insured risks, leading to a market failure because insurers were unable to assess and price appropriately for this risk. Some factors causing the market failure included:

- Likelihood of future attacks of similar scale (at least in terms of property damage) was unclear.
- The cost of these events is large and posed a material risk to insurers’ continued solvency if one were to occur.
- There is an aggregation of financial risk in built up areas, and particularly in CBD areas. Insurers rely on diversification to manage volatility in their retained risks.

Reinsurers, which provide support to local insurance companies for large events such as catastrophes, withdrew terrorism coverage globally. This meant that local insurers could not readily manage the level of retained financial risks, which is ordinarily accomplished through purchase of reinsurance treaties. Without reinsurance protection, local insurers had no choice other than to exclude cover themselves.

The Act established the Australian Reinsurance Pool Corporation (ARPC), which provides reinsurance coverage to commercial property insurers. This facilitated the return of insurance coverage for commercial properties for terrorism risk, with funding from a percentage of premiums and ultimately backed by a Commonwealth Guarantee.

The Act makes terrorism exclusions on commercial property insurance policies redundant if a Declared Terrorist Incident (DTI) is declared by the Treasurer. Reinsuring with ARPC is optional, with insurers able to provide cover themselves and/or purchase terrorism reinsurance elsewhere. However, due to the initial withdrawal of reinsurance capital and the redundancy of terrorism exclusions, initially all commercial property insurers reinsured with ARPC from its inception.

### 2.2 The insurance industry and ARPC’s role

In 2016/17, commercial property and critical infrastructure (e.g. utilities) insurance was a \$4 billion per annum industry<sup>2</sup>, providing protection for \$3.5 trillion of insured assets<sup>3</sup>. Commercial property insurance is primarily transacted through insurance brokers, with a small proportion sold directly to business customers (mostly for smaller businesses).

Insurance is provided primarily by Australian authorised insurers, which makes up around 90% of the market. The rest of the coverage is provided through foreign insurers, Lloyds’ of London, and captive insurers. Overall, there are over 180 separate entities which provide insurance coverage for commercial property in Australia, though the top 10 insurers make up more than 75% by premium volume.

Insurers purchase reinsurance to protect against an accumulation of risk and significant events (e.g. a cyclone or earthquake), as well as large claims on individual risks. Due to the advantages afforded by diversifying risk across geographical boundaries, reinsurers tend to be large multi-national entities based in reinsurance centres around the world (such as Singapore, London, Continental Europe, US, and Bermuda).

<sup>2</sup> APRA Quarterly General Insurance Performance Statistics – March 2018.

<sup>3</sup> ARPC 2016/17 Annual Report

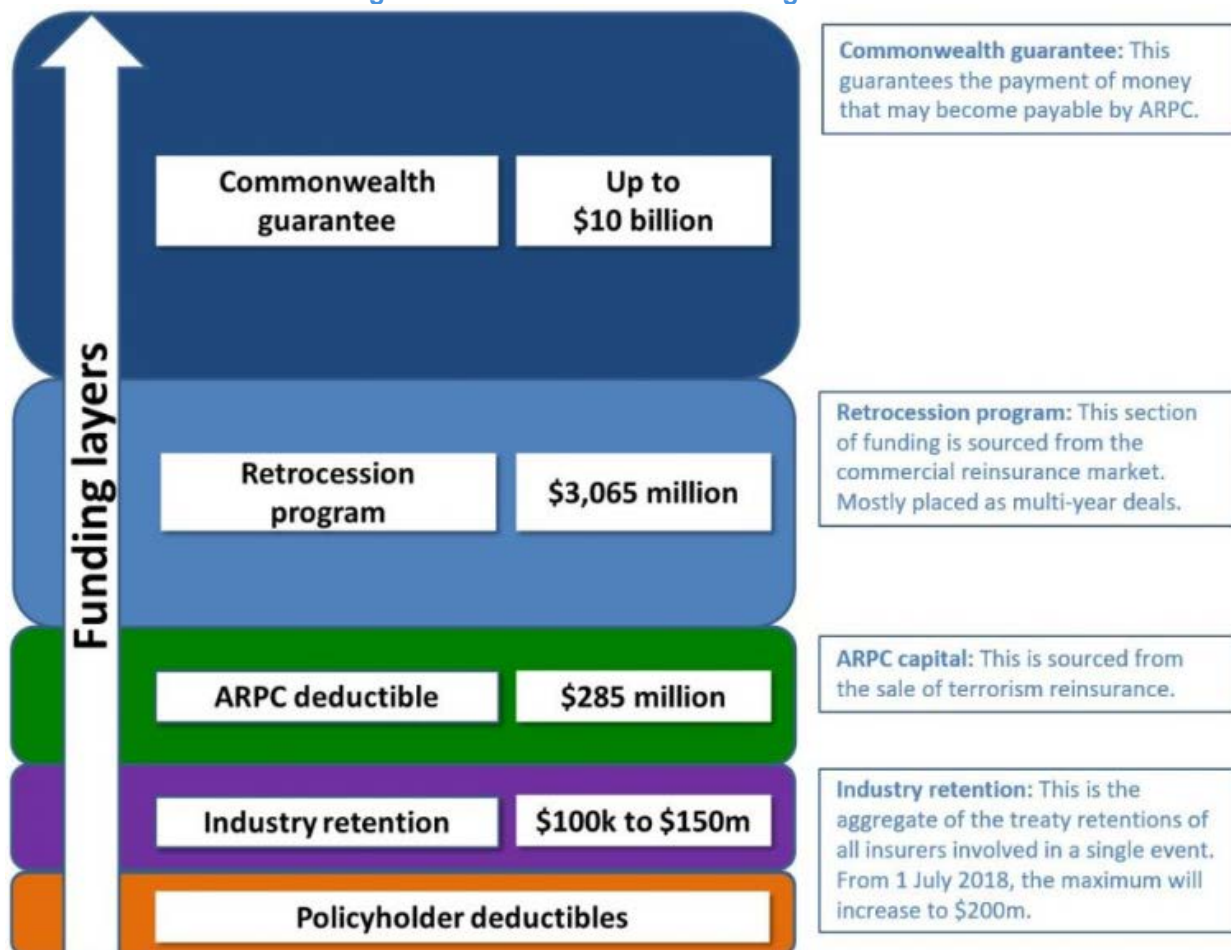
Insurance coverage is intended to align with the terms of reinsurance arrangements so that there are no gaps. Without reinsurance support, insurers will not take on some risks. This is what happened after the 11 September 2001 attack, where reinsurers excluded terrorism from their coverage terms leading to insurers doing the same.

ARPC is set up to operate as a reinsurer. In providing coverage as specified under the Act, ARPC offered Commonwealth supported coverage specifically for terrorism events. ARPC itself purchases its own reinsurance, which is known as retrocession.

### 2.3 ARPC’s coverage structure

The financial arrangements of ARPC are illustrated in Figure 2.1 below.

Figure 2.1 – ARPC Scheme Funding for 2018



Source: ARPC website

The Act sets out the following structure for insuring terrorism risk.

1. If a DTI is declared, insurance policy exclusions for terrorism are void and insurers are required to meet the cost arising from losses. Individual policy excesses/retentions apply as normal.
2. For insurers that reinsure with ARPC, the insurer must meet claims costs up to 5% of its annual fire and ISR premium, up to a limit of \$12.5 million. The insurance industry in total retains claims costs up to \$200 million (from 30 June 2018 onwards).

3. ARPC meets claims costs after the insurer retentions are exceeded. ARPC meets this cost through a combination of cash retained from premiums paid from insurers, retrocession coverage purchased (approximately \$3 billion), and a \$10 billion Commonwealth Guarantee.

Appendix B provides some background into the operation of reinsurance/retrocession markets.

## 2.4 Chronology of Triennial Reviews

The Act requires the Responsible Minister to prepare a report that reviews the need for the Act to continue in operation at least once every three years.

Table 2.1 below summarises the findings in respect of the continuing need for the Act from each review since the introduction of the Act. A more detailed summary of recommendations from each review can be found in Appendix C.

**Table 2.1 – Summary of previous triennial reviews**

Review	Key findings
2015	This review found that the current ownership and administration structure of the scheme should be retained, while noting scope to revisit alternative structures in future if there is a significant change in market conditions. As the need for the scheme has persisted for more than a decade, it was noted that the policy framework against which ARPC is assessed should no longer be limited to the scheme as a short-term temporary measure.
2012	The Review has found that some commercial market capacity for terrorism insurance is re-emerging both internationally and domestically, although it remains insufficient to cover the available demand and is concentrated in supporting national pooled arrangements. Furthermore, there is insufficient capacity at reasonable prices for individual risks in Australia, with the quantum of commercial market capacity being significantly below the current \$13.4 billion scheme operated by the ARPC.
2009	Despite improvements in the availability and affordability of terrorism insurance (subject to limitations), 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.
2006	The review concluded that there is still a need for the Act to continue in operation. The key features of ARPC are consistent with the best practice model supported by the Organisation for Economic Cooperation and Development (OECD).

The past four reviews found insufficient capacity for the commercial insurance market to provide terrorism insurance, while observing a return in capacity in some pockets. The previous reviews encouraged commercial sector participation through the retrocession and allowing alternative terrorism insurance to ARPC.

The most recent 2015 Triennial Review (“Previous Review”) identified that a single terrorism pool is likely to be the most cost-effective way to provide terrorism insurance cover. Private sector reinsurers expressed their preference to provide capacity to aggregated schemes such as ARPC. This was due to the risks being well understood as a result of risk modelling undertaken by ARPC.

## 3 Assessing market failure

### 3.1 Commercial participation within the ARPC system

The presence of ARPC means that underlying market failures cannot be directly observed. However, the design of ARPC allows commercial sector capacity for terrorism insurance through the following observable ways:

- (i) Commercial sector retrocession capacity provided from reinsurers
- (ii) Insurers electing not to reinsure with ARPC
- (iii) Standalone terrorism insurance.

These are discussed below.

#### 3.1.1 Learnings from ARPC's retrocession placement

##### *Available retrocession capacity*

For 2018 ARPC purchased \$3.065 billion of retrocession cover from the commercial reinsurance market at a total cost of \$58.3 million in premium, equivalent to a rate on line of 1.9% (generally considered to be a low rate). ARPC's retains the first \$285 million of annual costs relating to DTI, after which the retrocessionaires will be called upon.

ARPC received offers from reinsurers for over \$3.4 billion (of which it placed \$3.065 billion) at the rate on line offered. This capacity included a number of new markets that were prepared to support the ARPC. Of note is that this capacity is sourced from a combination of over 60 reinsurers, with the top 10 reinsurers contributing more than half of the total capacity. However, some smaller reinsurers only offered capacity of \$5 million. This suggests that it will be difficult to source material extra capacity outside of the major reinsurers as participants will likely each only offer small sums.

There were some major reinsurers that have previously participated in ARPC's retrocession program but declined to offer support for the 2018 retrocession program due to price considerations relative to their internal requirements. At higher prices, we would assume that these reinsurers might consider providing capacity to ARPC.

The following factors may influence the level of available capital that ARPC will accept in its program:

- Credit rating of the reinsurer. It is important to be confident that the reinsurer has the ability to pay even after a major DTI.
- Where the capital is coming from. There may be sources of capital which might be considered inappropriate for ARPC from a national interest perspective.

In the 2015 Triennial Review, the global capacity for Australian terrorism insurance risk was estimated to be around \$5 billion<sup>4</sup>. Our review of ARPC's retrocession program and discussions with reinsurance market stakeholders suggest current capacity is in the same order of magnitude (assuming reasonable restrictions on credit rating and capital origination), however the clarification on including biological and chemical attacks following the 2015 Triennial Review is likely to have reduced total capacity somewhat (i.e. it is estimated the available capacity may be closer to \$4 billion following this change).

<sup>4</sup> Page 10, "Terrorism Insurance Act Review: 2015"; Treasury

ARPC's pooling arrangement means that claims arising from a single DTI will be considered as one event, and the available capacity can be deployed to meet the cost of that event rather than be shared across multiple insurers. If each insurer had to independently purchase terrorism capacity, the total capacity required will be greater than the required capacity for a pooled solution.

### *Required levels of retrocession capacity*

ARPC provides \$13.4 billion of total cover for commercial property in the event of a DTI. The available capacity (\$4-5 billion) would not be able to provide a similar level of protection for Australian properties.

Having more capacity available provides better certainty for insurers and ultimately property owners in the event of a DTI. There is no amount of capacity that will protect against any and all possible DTIs, though "large but possible" events should be considered when assessing required capacity.

ARPC undertakes modelling of blast scenarios and the insured costs relating to these. This modelling suggests that commercial market capacity would not be sufficient to meet a maximum single event loss in Australia from a conventional blast, a scenario that ARPC was designed to protect against.

As context, the 11 September 2001 attack on the World Trade Centre resulted in insurance losses of US\$5.2 billion for Towers 1 and 2, US\$6.1 billion of other property damage, and US\$11.2 billion of business interruption (inflation adjusted to 2006)<sup>5</sup>. Additionally it is estimated that liability costs, which are also covered by ARPC, were US\$4.6 billion (excluding aviation liability). This was a total of about US\$27 billion for cover analogous to that provided by ARPC<sup>6</sup>. In Australian Dollars and at current values the equivalent would be about AU\$50 billion.

### **3.1.2 Alternative terrorism reinsurance capacity to ARPC**

Insurers are not required to reinsure with ARPC, and can instead protect their terrorism risk in other ways (note that the terrorism exclusion override in the Act will still apply). Notwithstanding this, we understand that almost all insurers elect to reinsure with ARPC. There are some exceptions; though these only represent a tiny share of the overall risk being insured (Finity estimates this to be less than 1%).

Major insurers we have interviewed suggest that periodic reviews are undertaken to test the reinsurance market to identify alternatives. Notwithstanding the potential cost of alternatives to ARPC, no major insurer has indicated to us that they have been able to identify plausible alternatives that have the capacity to protect the total of its commercial property risks for equivalent coverage.

As discussed above, an insurer will attempt to align the cover it offers with its reinsurance coverage. While there is capacity for conventional blasts, this capacity reduces significantly for biological or chemical attacks. Reinsurer limits on risk aggregation becomes a factor for larger insurers or if multiple insurers seek reinsurance outside of ARPC.

### **3.1.3 Standalone terrorism insurance**

A number of insurers offer standalone coverage for terrorism risk for commercial property. Standalone terrorism insurance might provide cover for terrorism which does not meet the requirements to be classified as a DTI (e.g. riots, civil commotion, political violence, etc.) and/or for properties outside of ARPC's coverage (e.g. overseas risks). Coverage can be tailored to suit the specific needs of each organisation.

<sup>5</sup> Hartwig, Dr. Robert P; "9/11 and Insurance: The Five Year Anniversary"; Insurance Information Institute, September 2006.

<sup>6</sup> There were also workers compensation, life insurance, marine and fine arts losses.

Standalone terrorism insurers will control the amount of risk by setting sum insured limits for any one property. This may mean that larger sized risks will require multiple insurers to participate. Insurers will also monitor their risk aggregation and will limit the total risks accepted in any one region, such as properties that are nearby to each other or on the same railway line. For example, an insurer may limit its sum insured for any one risk to \$200 million and total exposure within 250 metre radius of a location to \$400 million (example figures only).

Currently, standalone terrorism insurance allows for unique risk gaps to be filled. Standalone terrorism insurance coverage will not have sufficient total capacity to protect all properties that might reasonably purchase terrorism coverage across Australia, with these issues likely to be exacerbated in high risk CBD regions due to insurer limits on aggregation.

A recent example of the difficulties for individual risks in getting appropriate terrorism insurance is mixed-use and high rise residential buildings. These were included for the first time within ARPC after the previous review as it was found that a market failure existed for these properties, particularly those in central CBD areas. At the time the coverage for terrorism was available through some insurers, though for buildings in more central locations the premium was prohibitively high. This resulted in anomalies where commercial and residential buildings next to each other would have different coverage for terrorism. This issue was exacerbated by the growth in the number of mixed-use and high rise residential buildings and increasing size of the buildings, with some premium buildings amongst the tallest in CBD areas.

### 3.2 Terrorism is considered a separate risk

We note that for natural perils, reinsurers commonly provide coverage irrespective of the cause of the catastrophe. Typical catastrophe reinsurance arrangements only require a common single cause and for losses to be incurred within a specific time period (e.g. a storm cell causing damage within a 72 hour period). Reinsurers we spoke to suggest that they would not be inclined to incorporate terrorism insurance into a catastrophe cover due to the uniqueness of the risk and their need to monitor and limit exposure to this risk separate to other causes.

A reason for this is that natural catastrophes are well understood by insurers. This understanding of long term cycles of weather patterns across geographic regions means that capacity providers can price in periods of higher losses. The global reinsurance/retrocession market has the capacity to meet the cost of large events. For example, 2017 was considered a relatively bad year for natural catastrophes with 330 natural catastrophes leading to insured losses of US\$134 billion<sup>7</sup>. While there are indications that reinsurance premiums will adjust as a result of the poor results, this is not expected to cause significant disruption to insurance markets for natural catastrophes.

The same cannot be said for terrorism risk. As attacks are not random events, a terrorist event anywhere in the world may lead to withdrawal of capital in Australia. This implies that there will be resistance for terrorism risk protection to be incorporated into standard property insurance policies if the Act did not require it, and that available capacity will be closely controlled.

### 3.3 Difficulties in estimating claim frequency remain

Models exist to estimate the insured losses from a specified event (e.g. what might it cost if a 1,000kg TNT blast occurred at a location). However, it remains difficult to assess the probability of a specific attack. This uncertainty leads to reduced capacity levels.

<sup>7</sup> AON Benfield; "Weather, Climate & Catastrophe Insight"; 2017 Annual Report

### 3.4 Range of scenarios protected

Coverage under ARPC extends to biological and chemical attacks (with cyber being considered as part of Treasury's broader review). Based on our discussions with stakeholders, capacity to provide coverage for biological and chemical attacks is lower than for conventional blasts, and is unlikely to be available in sufficient volumes to meet requirements across Australia.



## 4 Other factors affecting need for the Act

The Act, and by extension ARPC, was established to respond to “what if” events. That is, it is designed to respond to a DTI if one was to occur. Market failure is an important, but not the only factor affecting the continuing need for the Act. The Act has broader implications for guaranteeing coverage and as a mechanism to fund losses, which are explored in this Section.

### 4.1 ARPC provides resilient capacity

As a “what if” arrangement, it is important to consider capacity following a DTI. Global reinsurance capacity may change based on general sentiment on the risk of a DTI. The Act provides resilience in the following ways:

- (i) An entity such as ARPC will continue to provide protection even after a DTI.
- (ii) The operation of ARPC essentially acts as an intermediary to global reinsurance capacity, which it can adjust according to the availability of cover.
- (iii) The \$10 billion Commonwealth Guarantee ensures adequate coverage even if there is no retrocession.
- (iv) The scheme provides for post-funding of losses after a major event.

Our discussions with stakeholders suggest that global reinsurance markets are better organised than they were ten to fifteen years ago and that capacity may not reduce dramatically following a DTI. This remains untested as we have not yet observed another attack leading to significant property damage since 11 September 2001. Notwithstanding this, ARPC’s structure allows it to adapt to changing market conditions by choosing to purchase more or less retrocession accordingly, while maintaining levels of coverage that aren’t materially affected by capacity issues.

### 4.2 Diversification leading to efficiency

An industry pooling arrangement is an efficient way to manage terrorism risk due to the benefits of diversification across the whole industry. These benefits accrue in the following ways:

- **Efficient use of available reinsurance capacity:** In a pooling arrangement, the available reinsurance capacity can be efficiently deployed to provide protection for the pooled maximum loss scenario. Without an industry pool, each insurer will be required to protect against its own maximum loss scenarios, the sum of which would exceed the maximum loss scenario of the pool. In this case, the available capacity will need to be shared between insurers.
- **Spreading of risk:** Without a pool, reinsurers will be exposed to a large loss if a property it covers is damaged. A pooling arrangement means that a reinsurer’s risk is diversified across all of Australia.
- **Encouraging reinsurer participation:** The current retrocession model allows reinsurers to know its maximum exposure to a DTI with certainty. This provides reinsurers with confidence, which generally leads to an increased willingness to participate. Similarly, ARPC allows global reinsurers to more readily accept terrorism risk in Australia and diversify the risk globally.

Pooling also allows efficient access to retrocession markets. As has been noted in previous reviews, diversification benefits are a reason why reinsurers prefer to participate in a pool arrangement, and to provide more capacity than otherwise possible.

Further, ARPC can vary its retrocession coverage to reflect price if this becomes expensive, thereby providing value to the Commonwealth and property owners.

### 4.3 Coverage for a range of events

The Act effectively guarantees insurance coverage to DTIs specified in the Act. For example, the Act makes it clear that conventional, biological, and chemical attacks would be covered. Without the Act overriding exclusion clauses for these events, commercial insurance coverage may provide cover for some of these risks only. Again, this will be more prevalent in high risk, high density areas.

From the policyholders' perspective, without the Act they would be required to make decisions around the types of terrorism insurance to purchase and the level of insurance. This would not be an issue for large organisations with sophisticated risk management functions. Given the complex nature of terrorism risk, small to medium commercial property and business owners may not be sufficiently informed about the protection they need and may have purchased. This increases the risk of underinsurance, not insuring a particular risk, or not properly understanding policy terms (such as sub-limits and reinstatements). The Act alleviates this information asymmetry issue.

### 4.4 Certainty to property owners

The market failure would mean that in the absence of the Act and ARPC, some property owners may find it difficult to purchase appropriate coverage and/or find that this coverage is prohibitively expensive. This is particularly so as buildings become larger (leading to higher sum insured values) and more centralised. Older buildings may also have difficulties in sourcing coverage as they may have fewer protections against terrorism when they were designed.

Critical infrastructure and utilities may also have difficulties in sourcing coverage without ARPC. This is not only due to their size, but also the potential for liability claim losses which are particularly difficult to estimate. ARPC currently provides liability coverage at no immediate cost.

As a pooling arrangement, ARPC provides certainty that cover will be available.

### 4.5 Central body to undertake research into exposure and risk

Section 3.3 noted advancements in understanding the potential size of insured losses if a DTI occurs and the relationship between better insights into understanding risk with the provision of capacity. An industry pool assists with developing research as it is easier to develop risk models at an aggregate level. Developing understanding of terrorism risk has played an important role in facilitating the return of commercial capacity in the form of the retrocession program, specifically detailed mapping of property exposures and blast modelling which ARPC undertakes.

ARPC being a government body means it can leverage insights on potential risks from security agencies. In addition to resolving market capacity issues, ARPC plays a broader role in providing protection for the Australian economy and in evolving its role to suit the changing economy.

## 5 Global comparisons

### 5.1 Renewal and formation of terrorism risk pools

There are over 20 overseas countries with terrorism pools or reinsurance mechanisms, including ten OECD countries. Schemes that have been subject to periodical review have been renewed, with new schemes established in Belgium (2008) and Denmark (2010).

### 5.2 Recent developments for comparable pools

#### 5.2.1 United Kingdom

The Pool Reinsurance Company Limited (Pool Re) was established in 1993 with the introduction of the Reinsurance Act 1993. Pool Re was established following the Baltic Exchange bombing by the IRA in 1992, which caused market failure in commercial property insurance for terrorism risk.

Pool Re pays claims up to the full amount of the fund held, after minimum aggregate industry retentions are met, with the UK Government guaranteeing to pay claims above the value of the fund. Any government support must be repaid from future premiums. Pool Re is a mutual reinsurer model primarily funded by premiums by policyholders. Membership is not compulsory and the UK Government receives a premium for coverage. Like the ARPC, Pool Re purchases retrocession coverage.

Following the September 11 attacks and the ensuing insurance market failure, Pool Re's cover was extended to cover "all risks" not just fire or explosion and exclusions relating to CBRN were removed. From April 2018, Pool Re extended cover to include material damage and direct business interruption caused by cyber terrorism, after two years of studying the risk and to address the gap in coverage.

#### 5.2.2 United States

The Terrorism Risk Insurance Act (TRIA) was enacted in November 2002 to overcome problems with availability and affordability of terrorism insurance following the September 11 attacks. The Terrorism Risk Insurance Program (TRIP) was established as the administrator.

Unlike our Act, TRIA is subject to periodic reauthorisation in order to continue. TRIA was extended in 2005, 2007 and most recently in January 2015 under the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA) through to 31 December 2020. The 2015 extension mandated that by 2020, the aggregate industry retention trigger for the program will increase and government share of losses will decrease.

During an eleven day gap period prior to the program being reinstated in early January 2015, some policyholders turned to stand-alone coverage to address the gap. Although private market supply was available, with additional insurers entering the market during this brief period, supply was very limited for non-conventional terrorism risks such as nuclear, biological, chemical or radiological.<sup>8</sup>

A permanent lapse of TRIA was not fully tested as the window of lapse was so brief. TRIA has strong support within Government<sup>9</sup> and the extension of TRIA was expected. Had the lapse being permanent

<sup>8</sup> Lerner, Matthew; 18 January 2015; "TRIA's temporary lapse sparks interest in private coverage of terrorism risks"; Business Insurance; accessed 25 June 2018; <<http://www.businessinsurance.com/article/20150118/NEWS06/301189984/trias-temporary-lapse-sparks-interest-in-private-coverage-of>>

<sup>9</sup> McDonald, Caroline; 17 December 2014; "Insurance Industry 'Disappointed' by Senate's Non-Renewal of TRIA"; Risk Management Monitor; accessed 25 June 2018; <<http://www.riskmanagementmonitor.com/insurance-industry-disappointed-by-senates-non-renewal-of-tria/>>

we suspect that terrorism exclusions may have been reintroduced. The eventual extension of TRIA was well received by the real estate and insurance industries<sup>10</sup>.

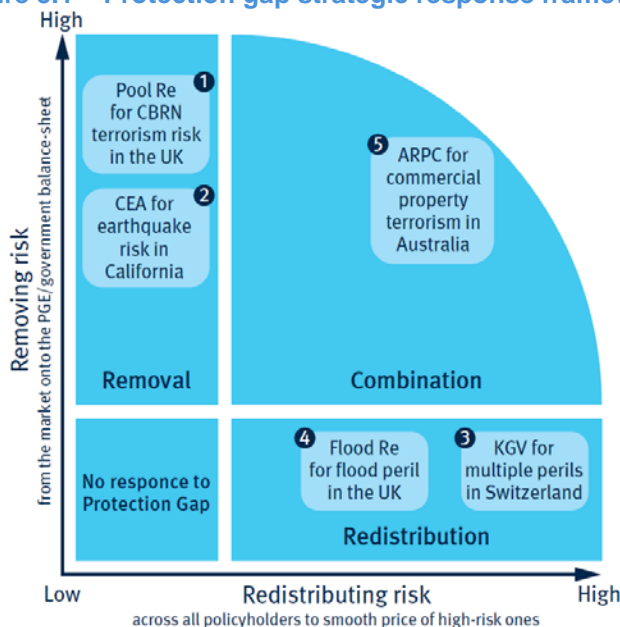
Under TRIA, the US federal government shares each insurer’s losses from acts of terrorism (after industry and insurer deductibles are applied) up to industry losses of US \$100 billion. Payments are subsequently recouped (only partially for losses above US\$60 billion) through surcharges on policies. There is no upfront reinsurance cost imposed on insurers for this protection, but TRIA requires all primary insurers to offer terrorism coverage to commercial clients. However, policyholders may decline and/or seek their own standalone cover. Since 2003, take up rates of TRIP has increased from less than 30% to more than 60%. Prices for terrorism insurance have steadily declined due to the protection offered by TRIP and improved risk modelling.

TRIP does not purchase reinsurance or retrocede.

### 5.3 Study of Protection Gap Entities

CASS Business School recently published a study<sup>11</sup> examining Protection Gap Entities (PGE) found globally. This study considered PGEs for a mature insurance market such as Australia, with ARPC specifically compared with other models that are adopted. Figure 5.1 shows a figure from this study which compares ARPC with other forms of PGEs.

Figure 5.1 – Protection gap strategic response framework



- 1 Remove all risk from the market to the PGE government
- 2 Remove risk to the PGE and return only some to the market (e.g. through reinsurance or insurers retention)
- 3 Redistribute all of the risk across all the policy holders
- 4 Redistribute some of the risk across all policy holders
- 5 Remove risk from the market to the PGE/government and redistribute across all policy holders

The study classifies ARPC as a Reinsurer PGE which is “best for responding to fluctuations in (re)insurance capital supply for a peril”. The Paper lists the following advantages of a Reinsurer PGE:

<sup>10</sup> McDonald, Caroline; 9 January 2015; “Congress Overwhelmingly Passes TRIA Bill”; Risk Management Monitor; accessed 25 June 2018; <<http://www.riskmanagementmonitor.com/congress-overwhelmingly-passes-tria-bill/>>

<sup>11</sup> Jarzabkowski, Prof. P. et. al.; “Between State and Market: Protection Gap Entities and Catastrophic Risk”, CASS Business School; 26 June 2018

- Addresses market failure in the reinsurance market by removing the risk from the insurance market.
- Acts as a price smoothing mechanism by redistributing risk when insurance premiums become unaffordable. For example, ARPC needs only to cover its own pooled and diversified exposure of all eligible risks in Australia without concern for profit or dealing with the higher volatility of a smaller portfolio.
- The insurance market is enabled to continue trading in risk whilst being able to transfer the proportion of risk it wants to the PGE.

The study highlighted that ARPC's operating model achieves a high degree of removing risk because losses are funded from the Commonwealth guarantee. Meanwhile, ARPC also achieves a high degree of redistributing risk through premiums paid by all policyholders to "restore traditional models of insurance".

The report made the following specific statements in regard to ARPC:

*"In scaling down risk removal [by increasing insurer retentions], the ARPC is thus working to address the problem of industry supply, by working with the primary insurance industry to help them supply some terrorism insurance from their own balance sheets. At the same time, because ARPC buys reinsurance cover itself, it has brought reinsurance capital to the market, further addressing the problem of capital supply. Yet the government balance sheet remains available for losses above the industry appetite to supply capital.*

*Hence, a combination of risk removal and risk redistribution, evolving within a legislative framework of three-year reviews have ensured that the ARPC continues to evolve in consultation with its stakeholders in government and industry, and the wider needs of Australian society."*

## 5.4 OECD Terrorism Pools Forum

In October 2015 the inaugural National Terrorism Reinsurance Pools Congress was held in London. This was subsequently followed by the formation of the International Forum for Terrorism Risk (Re)Insurance Pools (IFTRIP). The formation of forums such as these recognises the importance of terrorism risk pools and the continuing role they play in providing appropriate insurance protection within each nation.

## 6 Summary of findings and continuing need for The Act

### 6.1 Market failure conclusions

We conclude based on our investigations that there would likely be continued market failure in the absence of ARPC, or a similar alternative structure. This arises because of insufficient commercial market capacity to provide a plausible alternative to ARPC to offer terrorism insurance to properties that are likely to need it. This will particularly affect those properties with higher risk, which are arguably those that most require this coverage in the first place.

Even under the current ARPC structure, the available retrocession capacity does not meet the cost of a possible large loss event. Therefore, the \$10 billion Commonwealth guarantee continues to provide meaningful protection to commercial property insurance policyholders.

It is likely that market failure will be greater if insurers were required to match the broad range of cover offered by ARPC. Market capacity is expected to drop off noticeably for biological and chemical events. Similarly, the potential inclusion of cyber terrorism will again lower the available capacity, especially as cyber is a relatively new and quickly changing threat.

### 6.2 Other benefits of the Act

Notwithstanding market failure considerations above, there are other positive aspects arising from the continuation of the Act. The primary reasons include that it provides a minimum level of protection for real risks facing Australian properties, and by extension the broader economy. ARPC is an efficient mechanism for achieving this.

### 6.3 Continuing need for the Act

Due to continuing market failure, we opine that there is a continuing need for the Act currently and into the foreseeable future. An industry pool arrangement, like ARPC, provides a solution to this market failure while facilitating meaningful transfer of risk from the Commonwealth to the global insurance markets through retrocession.

## 7 Reliances and limitations

### 7.1 Distribution and use

This report is being provided for the sole use of The Treasury for the purposes stated above in this report. It is not intended, nor necessarily suitable, for any other purpose. This report should only be relied on by The Treasury for the purpose for which it is intended.

We understand that Treasury may wish to:

- Provide a copy of our report to the Minister as an attachment to Treasury's 2018 Triennial Review.
- As a result of making the 2018 Triennial Review public, release our report into the public domain.

Permission will be granted for such distribution of our report on the condition that the entire report, rather than any excerpt, be distributed. No other distribution, use of or reference to our report (or any part thereof) will be permitted without our prior written consent.

Third parties should recognise that the furnishing of this report is not a substitute for their own due diligence and should place no reliance on this report or the data contained herein which would result in the creation of any duty or liability by Finity to the third party.

Any reference to Finity in reference to this analysis in any report, accounts or any other published document or any other verbal report is not authorised without our prior written consent.

Finity has performed the work assigned and has prepared this report in conformity with its intended utilisation by a person technically competent in the areas addressed and for the stated purposes only. Judgements about the conclusions drawn in this report should be made only after considering the report in its entirety, as the conclusions reached by a review of a section or sections on an isolated basis may be incorrect.

The report should be considered as a whole. Members of Finity staff are available to answer any queries, and the reader should seek that advice before drawing conclusions on any issue in doubt.

### 7.2 Data and other information

We have relied on the accuracy and completeness of all data and other information (qualitative, quantitative, written and verbal) provided to us for the purpose of this report. We have not independently verified or audited the data but we have reviewed it for reasonableness and consistency.

## Part III Appendices

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### A Stakeholders interviewed

Finity acknowledges representatives from the following organisations that have provided input into this report.

#### A.1 Insurers

- IAG
- QBE
- Liberty
- XL Catlin
- Berkshire Hathaway Specialty Insurance

#### A.2 Reinsurers

- Munich Re
- Swiss Re
- Gen Re

#### A.3 Reinsurance brokers

- Guy Carpenter
- JLT Australia

#### A.4 Other stakeholders

- ARPC
- Lloyds' Australia
- National Insurance Brokers Association
- Owners Corporation Network
- BAC Brokers
- Aon Australia
- CHU
- Strata Community Insurance
- CASS Business School



## B Reinsurance and capacity

### B.1 Reinsurance protection for risk aggregation

To protect against large claims/events, insurers often use Excess of Loss (XoL) type arrangements. A XoL treaty indemnifies the ceding company for losses that exceed a specified limit. For example, an insurer may specify that it will retain \$100 million of cost arising from any one event (e.g. a severe weather event). Therefore if the event cost \$150 million in total, the XoL treaty will pay \$50 million to the ceding insurer.

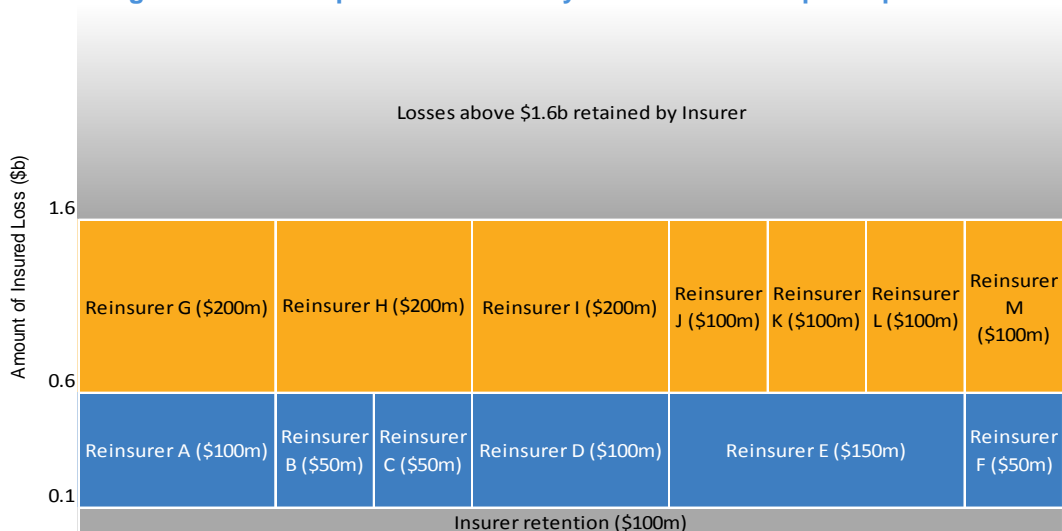
The XoL treaty will also specify a total limit of cover. In the example above, if the treaty specified a limit of \$200 million (conventionally termed as “\$200m XS \$100m”), the ceding insurer will retain liability for claim amounts above \$300 million for the event. The ceding insurer may, and often does, purchase additional “layers” of coverage to attach from \$300 million and above (e.g. they may place a second layer at \$200m XS \$300m, and a third at \$500m XS \$500m). The ceding insurer will consider the potential for large aggregations of claims based on the underlying risks it insures, its capital level, price of reinsurance, and appetite to retain risk in determining its retention levels and limits of reinsurance it purchases.

Note that ARPC’s retrocession program is a XoL treaty which attaches on an “annual aggregate” loss basis. That is, rather than tally the cost from a specific event, the XoL treaty pays when the total annual cost exceeds ARPC’s retention level.

### B.2 Placement of reinsurance and capacity

Reinsurance brokers assist insurers with designing the structure of reinsurance programs to suit the insurer (i.e. the deductible, limits, and layers) and with negotiating and placing the reinsurance in the market. Multiple reinsurers may participate on a single layer. This is illustrated in Figure B.1.

Figure B.1 – Example reinsurance layers and reinsurer participation



A reinsurer will consider the amount of capital it has available to put at risk, often called its “capacity”. For example, a reinsurer may consider its global portfolio risks and decide that it wants to allocate \$100 million of capacity for terrorism risk in Australia. Therefore, that means it can take 20% of the bottom layer in Figure B.1, which has a limit of \$500 million. Once allocated, the reinsurer will not generally accept more of this type of risk.

## C Recommendations from previous Reviews

Review	Key findings
2015	<p>This review found that the current ownership and administration structure of the scheme be retained, while noting scope to revisit alternative structures in future if there is a significant change in market conditions. As the need for the scheme has persisted for more than a decade, it was noted that the policy framework against which ARPC is assessed should no longer be limited to the scheme as a short-term temporary measure.</p> <p>Other recommendations included:</p> <ul style="list-style-type: none"> <li>● Increase insurer retention to 5% of premium (implemented)</li> <li>● Removal of maximum insurer retention levels (not implemented)</li> <li>● Industry retention increased to \$200 million (implemented)</li> <li>● Continue to have discretion to purchase retrocession (continuing)</li> <li>● Pay a fee to the Commonwealth (implemented)</li> <li>● Increase premiums charged (implemented)</li> <li>● Extend scheme to mixed use high rise buildings (implemented)</li> <li>● Clarify inclusion of biological or chemical attacks (implemented)</li> </ul>
2012	<p>The Review has found that some commercial market capacity for terrorism insurance is re-emerging both internationally and domestically, although it remains insufficient to cover the available demand and is concentrated in supporting national pooled arrangements. Furthermore, there is insufficient capacity at reasonable prices for individual risks in Australia, with the quantum of commercial market capacity being significantly below the current \$13.4 billion scheme operated by the ARPC.</p> <p>Other recommendations included:</p> <ul style="list-style-type: none"> <li>● Maintain premiums and retentions</li> <li>● Assess the appropriate capacity of the scheme at the next review (implemented)</li> <li>● Assess the continuing need for retrocession at the next review (implemented)</li> <li>● Re-examine mixed use high rise building at the next review (implemented)</li> <li>● Pay a dividend to the Commonwealth (implemented)</li> </ul>
2009	<p>Despite improvements in the availability and affordability of terrorism insurance (subject to limitations), 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.</p> <p>This review identified the following refinements to the scheme:</p> <ul style="list-style-type: none"> <li>● Continue to collect premiums and to investigate further retrocession (implemented)</li> <li>● Discontinue line of credit facility and to investigate additional retrocession (implemented)</li> <li>● Investigate extending the scheme to mixed-use high rise buildings (implemented)</li> <li>● Continue to exclude property wholly used for residential purposes (continues)</li> </ul>

Review	Key findings
	<ul style="list-style-type: none"> <li>● Review postcode allocation to tiers (implemented)</li> </ul>
2006	<p>The review concluded that there is still a need for the Act to continue in operation. The key features of ARPC are consistent with the best practice model supported by the Organisation for Economic Cooperation and Development (OECD).</p> <p>Other recommendations included:</p> <ul style="list-style-type: none"> <li>● Extend cover to public authorities (not implemented).</li> <li>● Encourage commercial sector involvement by: <ul style="list-style-type: none"> <li>▶ Continuing to charge premiums (continues to current)</li> <li>▶ Purchase retrocession or build the fund once the fund reached \$300 million (implemented)</li> <li>▶ Introduce insurer retentions (implemented)</li> <li>▶ Requiring ARPC premiums only on policies that exclude terrorism risk (not implemented)</li> </ul> </li> </ul>

## D Thought experiment: a scenario without the Act

In the absence of ARPC (or a similar industry pooling alternative) but assuming the Act continues to override terrorism exclusions, each insurer will be required to manage its own risk of a DTI. Insurers will consider potential event scenarios in determining the level of reinsurance purchased. This means that the available reinsurance capacity will need to be shared across all insurers as opposed to being made in full to a single industry pool. Based on our discussions with reinsurers and reinsurance brokers, we expect that in this case it is highly likely that the total required capacity will exceed the level which commercial reinsurers will provide<sup>12</sup>.

If the Act were to not exist, there would be no requirement for terrorism insurance to be provided (i.e. exclusion overrides would not apply, assuming the Act is not replaced). The following may occur in this scenario:

- Terrorism exclusions will not apply for some policies, but this will depend on the specific risk. Exclusions may apply for some causes, such as biochemical attacks. Ultimately, coverage will differ for each risk.
- Insurers will collect information relevant to terrorism exposure and will evaluate the risk on a case-by-case basis. There may be circumstances (e.g. a property houses a US or Israeli consulate) where they consider the risk too great and either decline to write the risk entirely or offer to cover it only with a terrorism exclusion or sub-limit. This is roughly analogous to what happens now with flood insurance. If the property owner is not able to find an insurer that will take on the full risk at an acceptable price, it will have two main choices:
  - ▶ Buy stand-alone cover just for the terrorism risk (at a price)
  - ▶ Go uninsured for terrorism risk which is likely to put them in breach of loan covenants and fiduciary obligations (the same situation that convinced the Treasurer to introduce ARPC in 2002).
- Insurers will need to decide what to charge for the terrorism risk. For a large majority of properties the answer will be a quite small amount. For a minority the increase will be material, and potentially unaffordable. In the short run insurers will likely charge higher amounts and, if experience is good, the rate would probably fall and become invisible for 'standard risk'. For properties with a higher assessed risk, however, individual risk assessment and pricing will continue for a long period.
- Reinsurers would evaluate exposure and risk of terrorism losses and would use this to determine what they are prepared to offer at what price and also to manage their total exposure across all insurers they cover (their accumulation). Technically this is difficult, but it is done in other circumstances. Sometimes it is supported by 'models' and there has been some development of terrorism risk models. The reinsurance industry will have sufficient capital to provide the necessary cover for Australia, but it is untested whether they will make enough cover and at what price available.

As individual risk assessment and pricing comes in there will be behavioural adaptations that will influence (to some extent) land use, commerce and development. To refer back to the example above a landlord may choose not to house a US or Israeli consulate because the impact on their terrorism risk

<sup>12</sup> A pooled arrangement may design a reinsurance arrangement around a probably maximum loss scenario having considered all risks insured. If each insurer was required to consider its own maximum terrorism loss scenarios, the sum of these scenarios will be significantly greater than the pooled scenario.

and insurance premium is too great. Properties next to higher risk properties may become unattractive. In the longer term though, new buildings may be designed to reduce the risk of terrorism related losses.

If there is one or more significant terrorism incidents resulting in claims, there is very likely to be insurance market reactions – declining to renew cover, increasing premiums, requiring exclusions or sub-limits. The claims that arose would very likely be paid, with the disruption influencing the market in future.

# **ANNEX B: AUSTRALIAN GOVERNMENT ACTUARY REPORT**



**Australian Government**  

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**Australian Government Actuary**

# **TERRORISM INSURANCE ACT REVIEW 2018**

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# TERRORISM INSURANCE ACT REVIEW 2018

## List of Acronyms and Abbreviations

AGA	Australian Government Actuary
APRA	Australian Prudential Regulation Authority
ARPC	Australian Reinsurance Pool Corporation
CBD	Central Business District
CMP	Capital Management Policy
DTI	Declared Terrorist Incident as defined in the <i>Terrorism Insurance Act 2003</i>
RBA	Reserve Bank of Australia
RoE	Return on equity
RoL	Rate on line

# TERRORISM INSURANCE ACT REVIEW 2018

## 1 Introduction

- 1.1 The Australian Government has established a terrorism insurance scheme in order to minimise the wider economic impacts of the withdrawal of terrorism insurance in the wake of the major attacks in the United States of America in 2001. The scheme is administered by the Australian Reinsurance Pool Corporation (ARPC). The government's objective is to operate the scheme only while sufficient cover is unavailable commercially on reasonable terms. As a result, the *Terrorism Insurance Act 2003* (the Act) requires that the Minister provides a report that reviews the need for the Act to continue in operation at least once every three years. The Treasury is currently conducting such a review of the Act.
- 1.2 As part of this review, the Treasury have asked the Australian Government Actuary (AGA) to provide advice on three matters:
- a) the appropriate level of net assets to be retained by ARPC to pay first losses and the retrocession reinsurance deductible;
  - b) the appropriate payment to Government for the Commonwealth guarantee and the appropriate dividend (or capital charge) to be paid to Government as the scheme owner; and
  - c) whether the overall level of scheme pricing remains appropriate.
- 1.3 The purpose of this report is to consider each of these topics. These topics are in some ways interdependent. For example, the nature of the scheme means that the Commonwealth guarantee (b) is only called on after the net assets (a) are exhausted. As a result, the appropriate price for the Commonwealth guarantee is dependent on the level of net assets retained by ARPC. I have chosen to address these topics in the order set out above. Readers of the report are asked to recognise the dependency noted in this paragraph.
- 1.4 The analysis in this report assumes that the current scope of cover provided by the ARPC remains in place. Should the scope of cover change, the conclusions in this report should be reviewed. A prudent first step would be to quantify the potential losses that could arise from any new head of damage and the premium to be charged.
- 1.5 The actuary responsible for the preparation of this report is Guy Thorburn FIAA, as the Australian Government Actuary. This report has been prepared with the support of the staff at the Office of the AGA.

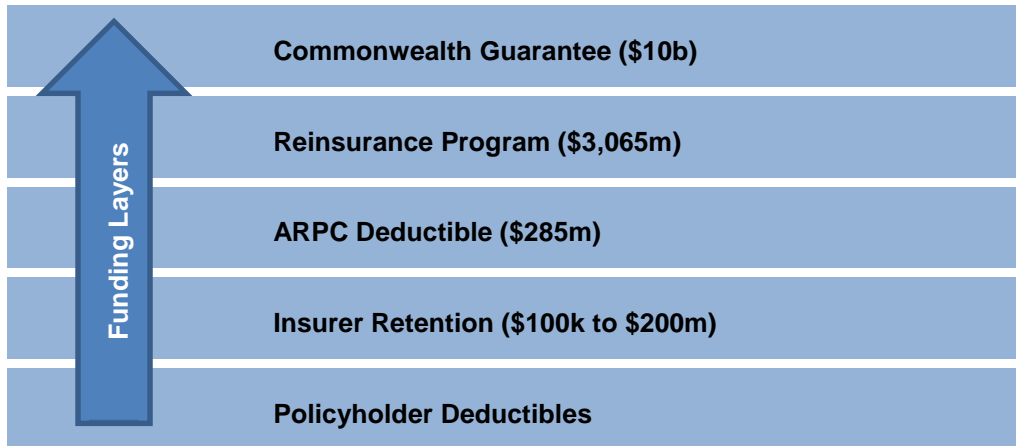
# TERRORISM INSURANCE ACT REVIEW 2018

## 2 Scheme Overview

- 2.1 The ARPC offers terrorism reinsurance to direct insurers in respect of eligible insurance contracts. Broadly, eligible contracts are those that provide insurance of eligible property, tangible contents and business interruption. The focus of the scheme is to provide reinsurance for commercial property. Residential property (with a sum insured under \$50 million) is not eligible property. Other forms of insurance (e.g. including but not limited to life insurance, health insurance, motor insurance and liability insurance) are also not covered.
- 2.2 Insurers are not required to purchase reinsurance from the ARPC. They are free to purchase reinsurance directly from the market. Where an insurer does enter into a reinsurance agreement with the ARPC then they pay a premium to the ARPC.
- 2.3 The reinsurance provides a benefit in the event of a declared terrorist incident (DTI) where damage is incurred that is covered by an eligible insurance contract. The scheme provides a benefit for the risks covered by the policyholder's insurance (i.e. over and above any retention by the policyholder) and over and above any retention by the insurer (between \$100,000 and the maximum insurer retention of \$12.5 million and the maximum industry retention of \$200 million).
- 2.4 The pool meets its liabilities through three key layers.
- The ARPC purchases retrocession cover, however this does not provide any benefit for events below \$285 million. Losses in respect of a DTI below this level are met by the net assets of the pool. Note that the amount of \$285 million can vary over time, depending on the reinsurance purchased by ARPC.
  - The amount of a DTI attributable to the ARPC that is above \$285 million is then met by the retrocession purchased by the ARPC. In 2018, this provided cover for the next \$3,065 million of claims.
  - Where the claim then exceeds \$3,350 million, the balance is met by calling on the Commonwealth guarantee. This is an explicit guarantee provided by the Commonwealth of \$10 billion (which appears to be per DTI). The guarantee is disclosed in the Commonwealth Budget as a contingent liability. Although the amount of the guarantee is significant and explicit the liability is unquantifiable and hence not recorded on the balance sheet.
- 2.5 Taking the policyholder and insurer retention into account, the structure of the scheme is commonly illustrated in the following manner.

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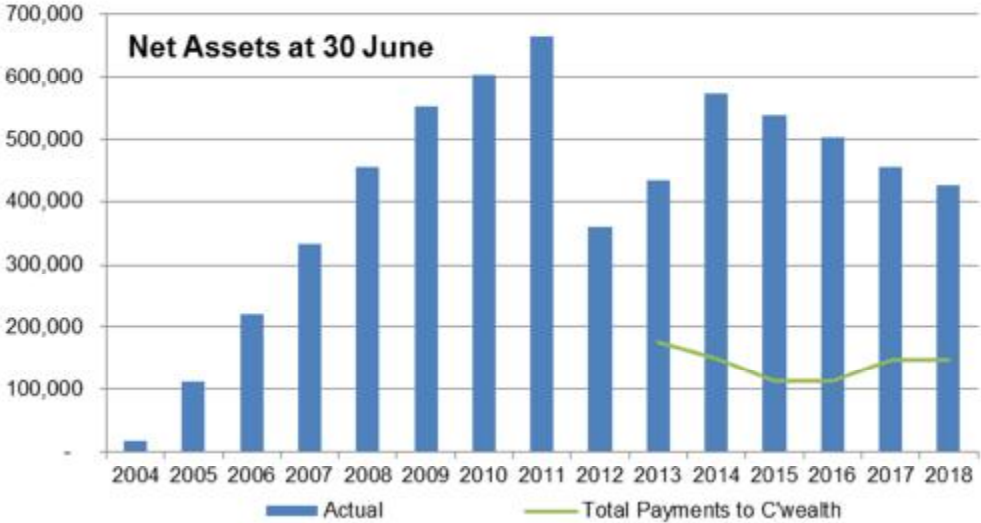
Figure One: Scheme Structure (as at 1 July 2018)



- 2.6 It is important to note that these layers are not necessarily insulated from each other. For example, the net assets of the scheme are designed to meet the \$285 million ARPC deductible layer. However a series of DTIs could exhaust the net assets. This, in turn, will result in the Commonwealth guarantee being called upon to meet this first ARPC layer in a subsequent claim. Similarly, changes in the reinsurance market from year to year may result in the need to change the deductible and upper limit of the reinsurance program. This would also impact upon the level of net assets required to be maintained by the ARPC, or the point at which the Commonwealth guarantee may be called upon.
- 2.7 In return for the provision of the Commonwealth guarantee, the ARPC pays a fee to the government. In addition, up to 2018, the ARPC paid a dividend to the Commonwealth as the sole 'shareholder' in the scheme to reflect the Commonwealth's capital at risk.
- 2.8 The historical experience of the net assets of the pool is shown in Figure Two.

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Figure Two: Progress of the ARPC Net Assets



2.9 Figure Two shows that the recent performance of the fund, along with additional payments to the Commonwealth, has seen the net assets of the fund reduce.

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### 3 Target Capital

- 3.1 The ARPC sets a policy regarding the net assets it will hold as capital. The policy is known as the Capital Management Policy (CMP). The capital held by the ARPC is its net assets, and these terms are used interchangeably in this report.
- 3.2 The policy notes that section 35 of the Act provides the ARPC with a Commonwealth guarantee and that this guarantee means that the ARPC can deliver its functions without the need to hold any capital. If the ARPC did not hold any capital, then the Commonwealth guarantee would be called upon in the face of all DTIs and the cost of the Commonwealth guarantee would be correspondingly higher.
- 3.3 The ARPC Board has determined that it is appropriate for the ARPC to hold sufficient capital to ensure that it can continue to function in the face of a DTI, 'except where significant claim liabilities arise from a DTI'.
- 3.4 The ARPC Board has set three capital thresholds for 2018 as follows:

<b>Minimum Capital</b>	<p>Provide sufficient capital for ARPC to meet its obligations for a significant, but not catastrophic, terrorism loss (approx. \$3 billion) without calling the Commonwealth guarantee.</p> <p>Represented by:</p> <p>Retrocession retention</p> <p>Normal operating costs</p> <p>Run-off claims handling costs</p>	<p>\$285m</p> <p>\$10m</p> <p>\$50m</p> <p><b>\$345m</b></p>
<b>Target Capital</b>	<p>Provide sufficient capital for ARPC to meet its obligations for a significant, but not catastrophic, terrorism loss (approx. \$3 billion) without calling the Commonwealth guarantee, as well as the ability to respond to retrocession market shocks or other market shocks.</p> <p>Represented by:</p> <p>Retrocession retention</p> <p>Normal operating costs</p> <p>Run-off claims handling costs</p> <p>Retrocession resilience factor – to cover increased retrocession premiums and or retentions</p>	<p>\$285m</p> <p>\$10m</p> <p>\$50m</p> <p>\$100m</p> <p><b>\$445m</b></p>

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<b>Maximum Capital</b>	Provide sufficient capital for ARPC to meet its obligations for a significant, but not catastrophic, terrorism loss (approx. \$3 billion) or two smaller terrorism losses over multiple years without calling the Commonwealth guarantee, as well as the ability to respond to retrocession market shocks.	
	This level of capital enables ARPC to continue to operate after a DTI without the need to recapitalise, but capital above this level could be considered inefficient use of Commonwealth capital.	
	Represented by:	
	Retrocession retention X 2	\$570m
	Normal operating costs	\$10m
	Run-off claims handling costs X 2	\$100m
	Retrocession market resilience factor – to cover increased retrocession premiums and or retentions	\$100m
		<b>\$780m</b>

- 3.5 Capital at 30 June 2018 was \$425.9 million, which is between the minimum and target levels of capital.
- 3.6 The **minimum capital** level is described as the amount required to meet the costs of funding a (single) DTI of up to ≈\$3 billion. This is simply the amount to which the ARPC is directly exposed along with a modest amount for run off expenses. In my view the ARPC should always stand ready to meet its obligations. Where the minimum level of capital is held, the ARPC is expected to be able to meet its immediate obligations (up to the ARPC deductible), however it is not expected to be able to afford to repurchase retrocession without that cost being funded by the Commonwealth. In this scenario, the ARPC would therefore need direct support from the Commonwealth to continue to operate. In my view, to protect the Commonwealth, the ARPC should always seek to operate with capital comfortably in excess of this minimum.
- 3.7 Should the ARPC hold the **target capital** then it is expecting to be able to meet the cost of one DTI up to \$3 billion. In this scenario, the ARPC would have met its obligations after a significant DTI (up to \$3 billion). It is also expected to be able to repurchase retrocession cover (\$100 million) after the event (expecting higher premiums after a DTI). As capital has largely been exhausted in this scenario, ARPC would be relying on the continuing Commonwealth guarantee to meet future claims below the retrocession retention. Capital holding fees to the Commonwealth would most likely cease as the pool rebuilds capital. Should the Commonwealth guarantee need to meet the first tier of the cost of future DTIs, then this would increase the relative cost of the guarantee. However, it is not certain whether the Commonwealth could increase the charge for the guarantee to the ARPC at the same time as the ARPC is rebuilding capital.

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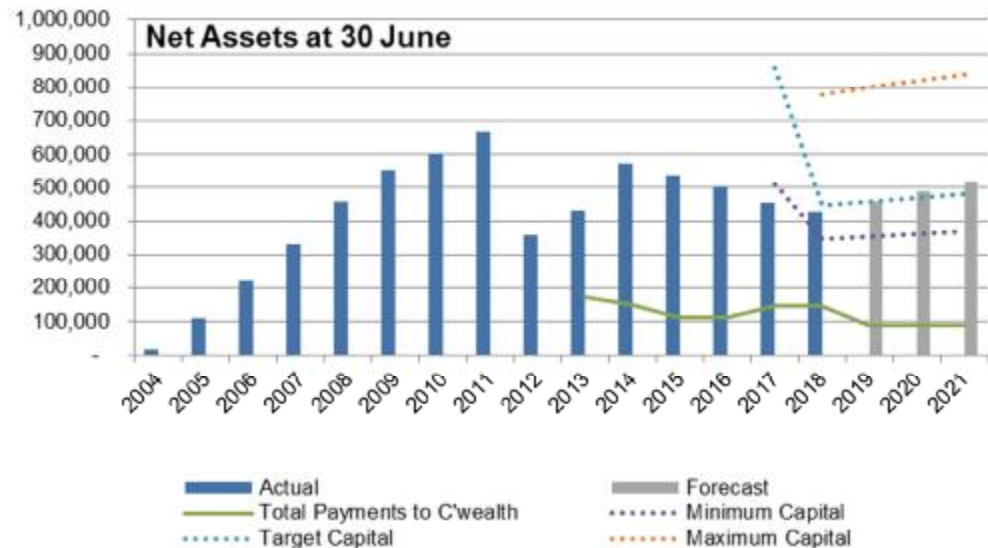
- 3.8 At the **maximum capital** level, the ARPC is expected to be able to continue to operate on a business as usual basis after the first DTI in excess of the retrocession retention.
- 3.9 Setting target capital levels inevitably involves a degree of judgement. The degree of judgement increases in the case of an entity like the ARPC, where (thankfully) claims frequency has been very low whilst the potential claim size is large and highly uncertain. It is important to acknowledge that there is room for a range of reasonable views regarding the level of the target capital.
- 3.10 Other factors relevant to the consideration of the target level of capital include:
- Whether it is desirable for a degree of resilience to maintain stable payments to the Commonwealth and premiums to reinsurers in the face of variations in reinsurance pricing.
  - Whether it is desirable to hold additional capital to enable the ARPC to increase its excess, thereby focussing its retrocession program on lower cost retrocession layers, in turn increasing its capital at risk. Alternatively, it may be desirable to reduce the excess to focus the retrocession at lower layers of protection.
  - The flexibility ARPC may seek to increase the scope of risk insured by the pool in the future.
  - Consideration of future capital needs that consider the expected growth in the scheme, allowing for growth in the numbers of buildings covered and for the effects of inflation on the sums insured to which the scheme is exposed.
- 3.11 It is important to acknowledge that the current capital management policy implies that the ARPC is targeting to be reliant on the Commonwealth guarantee to continue operating after one major DTI (e.g. ≈\$3 billion) occurs. Such a scenario would likely require a review of the premiums, retrocession, future capital and payments to the Commonwealth in the light of the DTI and any consequential changes to the insurance market following the DTI. It appears unlikely that the capital holding fee would continue at its current level (and may need to cease entirely) after a DTI in excess of the retention.
- 3.12 Some plans have been contemplated in the event of a DTI. Treasury is in the process of updating processes for responding to a DTI, which includes considering ongoing financial management of ARPC following a DTI and considering whether premiums, net assets and payments to the government would require adjusting.
- 3.13 The scheme currently operates below its target level of capital. A prudent insurer in this situation would have a plan to build their net assets to the level of their target capital within three years. To consider this, I have developed a three year forecast of ARPC's cash flows. Figure Three updates Figure Two with the inclusion of forecast net assets and future target capital (allowing for the current levels of target



## TERRORISM INSURANCE ACT REVIEW 2018

capital to increase at 2.5 per cent pa to provide some recognition of the expected need to increase target capital in future). Appendix A sets out the table that underpins Figure Three and describes the assumptions adopted in developing the forecast.

Figure Three: Forecast Net Assets and Target Capital



3.14 Figure Three shows that, on these assumptions, the ARPC is expected to grow its net assets over the next three years to exceed the forecast target capital by 30 June 2021.

3.15 In summary:

- The **target capital** is set at a level that implies that the ARPC will only be able to continue to operate after a major DTI (≈\$3 billion) by relying on the Commonwealth guarantee to fund the first layer of any further claims. At this time, the capital holding fee, and potentially, the guarantee fee, is likely to cease or materially reduce. This is analogous to the operation of the pool when it commenced. Target capital is adequate for this scenario, but no more. Should the Commonwealth wish to operate with a higher level of resilience, then the ARPC would need to increase its target capital, working towards the maximum capital documented in the current plan over time.
- When the ARPC is operating with net assets below its target capital, it is prudent to ensure that a plan is in place to meet its target capital within a reasonable period. A period of three years is generally considered reasonable. The forecast produced above illustrates that this outcome is expected to be achieved.
- It is recommended that Treasury considers the actions likely to be required following a material DTI to recapitalise the ARPC. Treasury should aim to

## TERRORISM INSURANCE ACT REVIEW 2018

ensure that all stakeholders are aware of government actions to be considered in the event of a DTI to protect the ongoing viability of the ARPC.

- 3.16 The adequacy of the net assets of the ARPC depends on the Commonwealth's view of the acceptable range of actions after a DTI. If the cessation of the capital charge and the inability to increase the guarantee charge (despite the guarantee moving to attach to the first layer of claims below the retrocession excess) is acceptable, then it may be arguable that the current target capital is acceptable. However, this leaves the pool and, in turn, the Commonwealth, more exposed to events than if target capital were higher. I would therefore regard the current settings as the minimum appropriate level. Allowing the net assets to grow steadily over time towards the maximum level set out in the CMP would increase the resilience of the pool.

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## 4 Payments to the Commonwealth

### 4.1 Overview

4.1.1 The terms of reference for the 2018 Triennial Review provide for a review of the appropriate level of payments to Government for fees for the Commonwealth guarantee and dividends (or capital charge) to Government as the scheme owner.

4.1.2 Payments to the Commonwealth have varied over time. Recent payments are set out in the following table:

Year ending 30 June (\$m)	2015	2016	2017	2018
Guarantee Fee	\$55.0	\$55.0	\$55.0	\$55.0
Capital Holding Fee			\$35.0	\$35.0
Special Distribution	\$57.5	\$57.5	\$57.5	\$57.5

4.1.3 The guarantee fee and the special distribution commenced in the financial year ending 30 June 2015. The special distribution is expected to cease at the end of the financial year ending 30 June 2018 and has therefore not been considered further in this report.

4.1.4 The ARPC is not a taxable entity. In this chapter I have, on occasion, benchmarked the ARPC against taxable private sector entities. To ensure a more like with like comparison, I have adjusted the ARPC performance for comparability. As the ARPC is a Commonwealth entity that exists due to a market failure, it is not acting in direct competition with the private sector. In that context, issues of competitive neutrality may not be the primary concern. As a result, I have not considered if ARPC should make a separate payment to the Commonwealth in lieu of tax.

### 4.2 Commonwealth Guarantee Fee

#### Background

4.2.1 The Commonwealth provides a government guarantee through a \$10 billion line of credit. Given the capital structure of the pool, in the current operating environment this effectively operates like a layer of retrocession purchased by the pool from the Commonwealth in excess of \$3.3 billion (being the combined ARPC deductible and retrocession purchased by the pool from the commercial sector). Since 2014/15 and as a result of the recommendation of the 2015 review, the ARPC has paid a fee of \$55 million pa for this “layer” of cover. This is equivalent to a rate on line (RoL) of 0.55 per cent of the guarantee and was set to be less than what commercial reinsurers were expected to charge.

#### Nature of Commonwealth guarantee

4.2.2 The role of the Commonwealth guarantee (in the context of a pool with sufficient net assets to fund its own deductible) is to provide cover in the event of a very large DTI. ARPC’s own capital and retrocession program is intended to absorb all but the

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largest DTIs. A key conclusion of the 2015 review was in relation to the nature of the Government support. The review concluded that the guarantee is essentially identical to retrocession cover. In my opinion, this is a reasonable view for the purposes of arriving at a cost for the guarantee and it is the view I have taken in preparing my advice.

4.2.3 If we view the guarantee as a layer of retrocession, then it is worth acknowledging that the guarantee does operate differently from private reinsurance in some important ways:

- There is no explicit repurchase requirement in the event of a claim, so the fee paid for this guarantee implicitly applies for any number of DTI events in a single year. This is different to excess of loss reinsurance cover typically purchased in the private market, where the cover (broadly) applies for the first claim in excess of the insurer's retention and a repurchase premium is required if additional cover is required after the first claim is paid in a given year.
- The point at which this layer of cover attaches is somewhat fungible. Should the ARPC's net assets be eroded by the occurrence of multiple DTIs, the guarantee would be called upon for claims below the current retrocession excess of \$285 million, potentially from the first dollar of ARPC liabilities. This would not occur in private sector reinsurance arrangements. In this sense, the guarantee is providing both a layer of reinsurance for exceptional events, a 'back up' first layer of cover whilst the ARPC's own resources are replenished after claim events and a 'back up' layer of retrocession in the event private reinsurance capacity prohibits the ARPC renewing their existing retrocession. Private retrocession would not shift to a different point of attachment or layer in the event of changing circumstances.
- Following a call on the guarantee, there is provision for ARPC's premiums to increase, up to three times, whilst the amount of the guarantee that was utilised is repaid.

The first two of these points would suggest that the guarantee has a higher value than equivalent reinsurance, whilst the last (if it is achievable in practice) would act to reduce the value of the guarantee. Given the uncertainty in the analysis I have made the implicit assumption that these three factors cancel each other out.

4.2.4 The presence of the guarantee provides additional benefits to insurers. The Commonwealth's credit standing means that there is no prudential capital required (by direct insurers) to be held in respect of reinsurance placed with the ARPC. In addition, (perhaps more broadly than just the guarantee) the legislation provides for the Minister to declare a reduction percentage on losses exceeding the combined capacity of the scheme, effectively allowing a percentage of claims against direct insurers to be waived. These factors indirectly add to the value of the scheme.

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- 4.2.5 On balance, the factors above suggest that the direct and indirect value provided by the guarantee is likely to be no less than the cost of an equivalent layer of reinsurance.

### **The current fee for the guarantee**

- 4.2.6 The fee is intended to compensate the Commonwealth for the risk it assumes in providing a significant financial guarantee. This principle is articulated in paragraph 3.15 of the explanatory memorandum to the *Terrorism Insurance Bill 2002*. The ARPC makes a payment to the consolidated revenue fund by 30 June of each year under a ministerial direction. The payment is funded by charging a premium to insurers that purchase reinsurance from the pool. The fee of \$55 million has been fixed for a number of years. The previous AGA has reported that this fee was set on the basis of the Commonwealth acting as a 'benevolent insurer' and was set to provide reasonable, but below market, compensation for the risk that was being accepted.
- 4.2.7 If the guarantee was a layer of retrocession purchased from the commercial sector, the price that would be charged will depend on the risk assumed and the reinsurer's cost of capital. At the last review, the Pottinger report found that, at the attachment point of the guarantee, the price is driven largely by the cost of capital, with a negligible allowance for risk of claims. Specifically, for layers of cover with high points of attachment, a minimum RoL applies. The current RoL for the highest level of attachment purchased by the ARPC is 1.413 per cent. This implies that one estimate of the cost of the \$10 billion guarantee is around \$140 million pa at current market prices.
- 4.2.8 It is open to the Government to act benevolently by charging a fee that is below commercial rates. I observe that the Government has also acted as a benevolent reinsurer in the face of market failure when providing reinsurance to medical indemnity cover.
- 4.2.9 The case for the Commonwealth guarantee fee being below perceived market retrocession rates could extend beyond the 'benevolence' of the Commonwealth seeking to support the economy in the face of a market failure. As a government owned entity, the Commonwealth retains any operating surplus generated by the pool. Whilst the pool should generate a fair return on capital for the owner, if higher returns are generated they are retained by the Government and could be considered to go some way toward compensating for the 'benevolent' price, the additional flexibility provided by the guarantee, or both.

### **Determining a fee for guarantee**

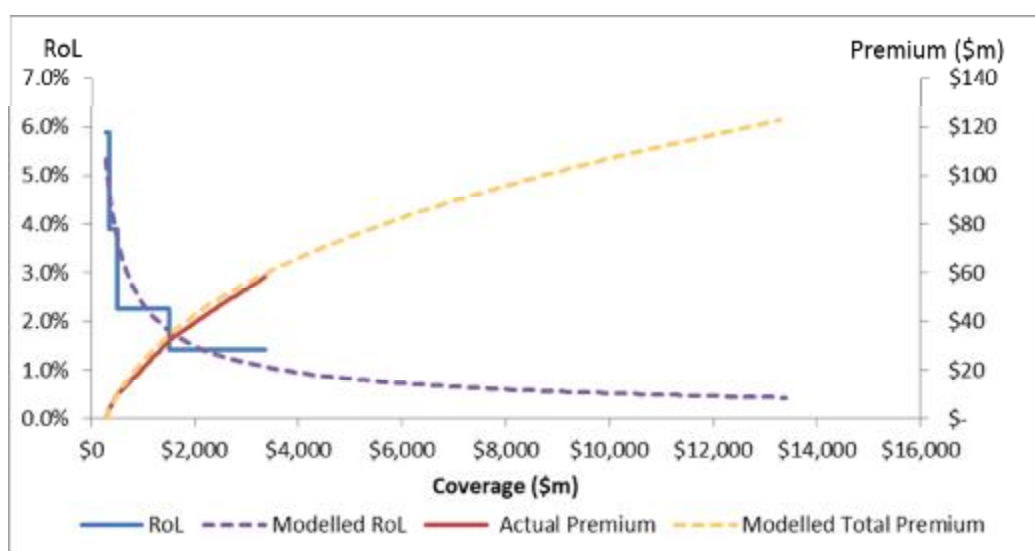
- 4.2.10 Catastrophe risks are difficult to price for insurers due to the low frequency and potential high costs of these events. While the potential impacts of acts of terrorism are increasingly understood from ARPC's modelling (GeoScience Australia), the incidence of attacks remain difficult to estimate due to the limited experience of the

## TERRORISM INSURANCE ACT REVIEW 2018

scheme to date. Terrorism events present additional challenges as they are not random in nature and their incidence is dependent on the combined result of the activity of terrorist groups and counter terrorism capabilities.

- 4.2.11 The Commonwealth guarantee provides a layer of retrocession that is above what the commercial reinsurance market is capable of fulfilling. In the absence of observable market prices at high attachment points, I have relied on ARPC's current retrocession program pricing (brokered for \$3,065 million in excess of \$285 million), along with a number of simplifying assumptions, to estimate a fee. I have fitted a curve using regression analysis to the RoL. This results in a modelled premium pricing curve that I have used to extrapolate a cost for reinsurance beyond \$3,350 million. I have assumed that the RoL would fall gradually until it reaches around 0.4 per cent, which represents a declining and negligible risk component. Figure Four illustrates the actual RoL and its associated total premiums as well as the modelled RoL and its implied total premiums.

Figure Four: Retrocession RoL



- 4.2.12 The modelled result implies a fee of approximately \$65 million for the \$10 billion guarantee. This is significantly less than the \$140 million suggested by the minimum RoL. The \$65 million fee arrived at by this model supports the view that the current \$55 million fee is aligned with that of a benevolent insurer.
- 4.2.13 There is some uncertainty when forming any view regarding the value of the guarantee. The result depends on both the model fitted and the current level of reinsurance prices, against which the model is fitted. In light of this uncertainty, I do not regard the result of this analysis to be materially different to the results obtained at the prior review. Based on this analysis I believe a reasonable fee for the guarantee lies in the range of \$55 million to \$65 million pa.

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### 4.3 *Capital Charge for Exposure of Commonwealth Funds*

4.3.1 ARPC also pays a capital charge for the exposure of the Commonwealth's capital in the pool. This commenced in the financial year ended 30 June 2017 and has been fixed at \$35 million pa. This compares to an operating result before Commonwealth payments of \$63.2 million in 2018 and capital (net assets) at 30 June 2018 of \$425.8 million. The charge was approximately 55 per cent of the operating result.

4.3.2 The payment of \$35 million was determined as part of the 2015 review. At that time, Treasury commissioned an external review (Pottinger), which estimated that the cost to the ARPC to reinsure the first \$360 million of losses in the private market, which would currently be funded using the capital retained by the ARPC, would be between \$30 million and \$70 million. A similar but intentionally more conservative value of \$35 million to \$50 million was calculated by the AGA. The AGA's more conservative estimate of \$35 million was considered more appropriate than a full commercial rate and was considered to represent fair compensation for the provision of around \$500 million in Commonwealth capital. Since that time, the amount of capital in the pool has reduced through transfers to the Commonwealth. In addition, the pool retention has reduced from \$360 million to \$285 million, reducing the level of risk for this first tier of capital.

4.3.3 There are two lenses through which an adequate level of capital charge might be assessed.

- Return on Equity (RoE)
- Cost of Reinsurance

#### **Return on Equity**

4.3.4 Through the lens of RoE, I have considered the question of the adequacy of the capital charge in two steps; essentially as one would when examining a dividend payment. The first question is whether the level of pool profitability is reasonable (i.e. as a rate of RoE) and the second is whether the charge is a sustainable distribution of profit.

4.3.5 The recent RoE generated by the ARPC is as follows:

Year	Result	Gross RoE	≈ Net RoE	Dividend \$	Dividend %
2016	23,477	4.3%	3.0%	-	0%
2017	43,999	8.4%	5.9%	35,000	80%
2018	63,217	13.0%	9.1%	35,000	55%

4.3.6 Through this lens, 2018 generated a RoE of 13.0 per cent before tax (or roughly 9 per cent after 'tax'). Viewed another way, this is the risk free (cash) rate plus 7 per cent after tax. It is reasonable that the return should provide a significant margin above risk free rates as the capital held by ARPC may not be repaid in the event of a major DTI event.

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- 4.3.7 Quantifying an appropriate RoE is a matter of judgement. APRA has published the RoE for reinsurers in the general insurance industry which shows that reinsurers generated a return on capital in the range of -1.2 per cent pa to 8.6 per cent pa (after tax) over the past 5 years<sup>1</sup>. In 2014, *Pottinger* stated that a private sector owner would expect to achieve a minimum return on capital of 10 per cent to 12 per cent post tax. It is reasonable to expect that ARPC should be above the average RoE achieved by the market in years where no claims have arisen against the ARPC. In this context, I do not view the (pre-tax) RoE in 2018 as unduly high.
- 4.3.8 Whilst this lens suggests the payment to government is a sustainable portion of profit, it highlights two issues with the fixed structure. Considering the result as a RoE suggests that the target operating result should vary in proportion to the capital at risk. The follow on from this is that the capital charge could also vary proportionately to the operating result, and therefore the capital held by the pool.
- 4.3.9 I recommended that Treasury give consideration to adopting a target operating result based on a target RoE (e.g. RBA Cash Rate + 10 per cent before tax) and a dividend target that is a percentage of the operating result. The target could be set with a view to building the target capital in the pool over time. This approach would provide for the target operating result and dividend to vary with capital, and importantly to automatically reduce dividend expectations following a DTI (when capital had been utilised). This would assist the ARPC to rebuild capital. The capital charge could also be increased to 100 per cent of the operating result when capital is in excess of the upper limit of the target capital. To remove volatility and assist in planning, the dividend amount could be specified (in dollar terms) in advance (based on a best estimate forecast) and reviewed as part of the triennial review of the Act.
- 4.3.10 The forecast presented in Appendix A illustrates that the ARPC is expected to meet the target RoE above and exceed target capital within three years. By way of an example to illustrate the effects of the process outlined in the previous paragraph, this forecast would suggest (assuming the guarantee fee is held at the current level) that:
- The ARPC is expected to generate a gross RoE in line with a target set by reference to the risk free rate + 10 per cent, and
  - It is open to the government to consider increasing the proportion of operating surplus distributed to government from 55 per cent to 70 per cent (i.e. \$45 million) and still meet the requirements of distributing a sustainable share of the operating surplus and meet target capital by 30 June 2021.

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<sup>1</sup> APRA Quarterly General Insurance Statistics, March 2018



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## Retrocession Fee

- 4.3.11 An alternate approach to viewing the capital charge as a return on capital at risk is to view the charge as payment for the first layer of retrocession. The ARPC retrocession program, affected with private reinsurers, commences at an excess of \$285 million. ARPC therefore retain all risk up to this amount. Target capital of ≈\$450m therefore provides \$285m coverage for the first DTI and a further amount to cover increased operational costs in the face of these claims.
- 4.3.12 A perspective on a suitable capital charge could be obtained by considering the price paid for the lowest layers of reinsurance. The RoL is the term used for the price a reinsurer charges for the retrocession layer. The RoL increases as the excess reduces. The RoL for the cover with the lowest excess purchased by ARPC (\$65m in excess of \$285 million) is 5.9 per cent. By contrast, the RoL for the highest excess (\$1,500 million) is 1.4 per cent<sup>2</sup>. The 2018 RoL at various levels of cover is illustrated in Figure Four, above.
- 4.3.13 The fitted curve can be extrapolated towards the y-axis. It is important to acknowledge that the curve illustrates one possible trend and that there is some judgement involved. However in the absence of more detailed data, this might imply that a realistic, but speculative, estimate of the cost of a retrocession at this layer might be around 10 per cent to 15 per cent of the \$285 million, or \$28.5 million to \$43 million. If we consider that the costs of administering these claims and operating the ARPC could consume additional capital (\$345 million), the resulting premium would be higher.

## 4.4 Summary

- 4.4.1 Considering the costs of retrocession and assuming that the guarantee fee is akin to a layer of retrocession that is only called upon for claims in excess of \$3.3 billion suggests that a reasonable fee for the guarantee lies in the range of \$55 million to \$65 million pa. There is considerable judgement in forming this view and it also assumes the Commonwealth continues to act as a “benevolent reinsurer” and does not seek to impose a commercial minimum RoL. I believe this approach is reasonable given the different nature of the Commonwealth compared to a commercial reinsurer.
- 4.4.2 Determining an appropriate level of capital charge also requires judgement. Further, it is possible to view the capital charge in different ways. Through both the lens of a share of a reasonable commercial operating result or as a RoL suggests that the capital charge of \$35 million remains reasonable.

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<sup>2</sup> Source: ARPC final retrocession signings, 2018

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- 4.4.3 However, there is scope for the approach taken to the capital charge to be more responsive to the emerging capital position of the pool, whilst supporting the steady growth in capital over time. This would entail setting a target RoE (e.g. cash plus 10 per cent) and setting the capital charge as a corresponding share of the resulting target operating surplus. The percentage would be set with regard to the speed at which it was deemed desirable to build capital in the pool. Should predictability of the charge be an important consideration, amounts could be set three years in advance using best estimate forecasts and applying the targets as a guideline. Through this lens, the ARPC is expected to generate an acceptable operating surplus. Should the government seek to increase the proportion of operating surplus that is distributed, an upper limit of \$45 million pa is expected to still see the ARPC achieve its target capital in three years.
- 4.4.4 All payments should be reviewed in the event of a DTI.

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## 5 Scheme Pricing

5.1 The purpose of this section is to examine the level of pricing currently charged by the scheme to insurers. Determining a fair price to be charged is inherently challenging. Whilst the ARPC has developed significant capacity to model the potential losses that could occur in a range of scenarios, estimating the probability of such an event occurring remains inherently problematic. The ARPC has not experienced any claims since its inception. In this context, the ARPC is dependent on a stable and effective security environment.

5.2 This report reviews the adequacy of the aggregate premiums generated by the ARPC. It does not review the individual premium rates by tier as data is not available at this time.

### Current Pricing

5.3 The ARPC currently charges insurers a percentage of the premium (excluding GST, stamp duties and fire service levies) that the direct insurer charges their policyholders on relevant insurance contracts. Pricing is set by a ministerial direction and has been reviewed over time. The last direction was made on 18 December 2015. A recent history of the premium rates is set out in the following table:

Year	Tier A	Tier B	Tier C
2012/13	12%	4%	2%
2013/14	12%	4%	2%
2014/15	12%	4%	2%
2015/16 <sup>3</sup>	16%	5.3%	2.6%
2016/17	16%	5.3%	2.6%

5.4 Tier A, B and C refer to postcodes.

- Tier A postcodes are the major centres of the main capital cities. These are listed in the direction as postcodes 2000, 2009, 2060, 3000, 3005, 3006, 3008, 4000, 5000, 6000 and 6003. These are the major capital cities of Brisbane, Sydney, Melbourne, Adelaide and Perth. The list includes the immediate surrounding areas that are similarly developed such as North Sydney and Docklands in Melbourne. It does not include smaller areas that may have a significant number of large commercial or high value residential properties (e.g. Chatswood or Gold Coast).
- Tier B postcodes are generally other urban and suburban postcodes with populations over 100,000 that are not tier A. This is a long list of postcodes

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<sup>3</sup> Increase effective April 2016

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and has the potential to cover a more heterogeneous mix of property. The list is set out in the *Terrorism Insurance Act 2003 – Premiums Direction 2017* and can be seen to include areas such as Canberra, Darwin and Surfers Paradise along with suburban residential areas. The list was last updated on 1 January 2018.

- Tier C postcodes are those not allocated to Tier A or Tier B.

5.5 Premium rates should be reviewed after a DTI.

### Aggregate Pricing

5.6 A broad lens, through which the adequacy of pricing may be judged, is to consider the adequacy of the overall premium revenue generated by the ARPC to meet its annual costs. This can be done by examining the net cash flows in recent years. This is summarised in the following table.

Summary (\$,000)	2014	2015	2016	2017	2018
Premium Income	129,708	128,134	126,172	147,208	169,625
Reinsurance Expense (Net of Commission)	- 74,122	- 64,293	- 56,884	- 55,593	- 56,390
Guarantee Fee	-	- 55,000	- 55,000	- 55,000	- 55,000
Expenses	- 9,055	- 8,012	- 8,191	- 8,366	- 8,718
Investment Earnings	26,531	21,337	17,230	15,574	13,675
Sub Total	73,062	22,166	23,327	43,823	63,192
Distribution	68,990	- 57,500	- 57,500	- 57,500	- 57,500
Capital Holding Fee	-	-	-	- 35,000	- 35,000
<b>Net Cash Flow</b>	142,052	- 35,334	- 34,173	- 48,677	- 29,308

5.7 Examination of the row titled 'Sub Total', in the above table, shows that the ARPC has produced a surplus in each of the last 5 years, before distributions and capital holding fees. The pool has benefited from reducing reinsurance premiums, which (net of commission) have reduced from 70 per cent of premium income in 2011 to 37 per cent in 2018. Distributions and capital holding fees have resulted in a negative net cash flow and a reduction in the net assets of the pool from 2015.

5.8 In 2018, the pool generated \$63 million of surplus, before distributions. Whilst distributions resulted in a negative net cash flow for the year to 30 June 2018, once the \$57.5 million distribution ceases, it is expected that the pool can generate a positive net cash flow after a \$35 million capital holding fee. Note that the \$57.5 million distribution is planned to cease at 30 June 2018.

5.9 This aggregate analysis suggests that, assuming the Commonwealth is comfortable with the implications of the capital management policy, the continuation of the current guarantee fee and the RoE provided by the \$35 million annual payment, then the overall level of pricing by the scheme is adequate in the current climate. Assuming the increased premium income experienced in 2018 is likely to continue provides some confidence in the adequacy of premium rates in the near term.

5.10 Regardless of recent experience, it is important to remain alert to the fact that there are risks to this position. ARPC premium income is a percentage of the premiums charged by direct insurers. If direct premiums soften then ARPC premium income

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will reduce. Similarly, market forces could impact retrocession premiums. In either scenario, ARPC may need to increase premiums to ensure it continues to operate on a sound financial basis. This does not invalidate the conclusion, it simply highlights the need to continue to monitor scheme pricing on a regular (e.g. annual) basis.

### **Profit Margin**

- 5.11 An additional perspective to the analysis set out above is to consider whether the net profits generated by the ARPC are in line with margins generated by commercial reinsurers. APRA quarterly statistics<sup>4</sup> show that the net profitability of reinsurers (after tax) over the last 5 years has ranged from -2 per cent to 21 per cent of premium and has averaged 6 per cent of premium. By contrast the average profitability of ARPC over the same period (and assuming the guarantee fee applied for the full 5 years and reduced by 30 per cent to allow for tax to be comparable) represented by the operating result before the distribution and capital holding fee was 22 per cent of premium during a period where there were no claims. ARPC profitability should be higher than the industry in a period where no claims occur as significant losses are expected in a year that a claim arises. In the absence of adequate claims experience, this does not suggest premiums are unreasonable.

### **Postcode Level Pricing**

- 5.12 As noted earlier, premiums are set at postcode level. The postcode categories are reviewed following recommendations by ARPC to the Minister. When they change, they will then form part of a new direction.
- 5.13 There is the potential for the list of “CBD like” postcodes to date as the population grows and new “CBD like” areas to emerge, for example where a concentration of high value buildings (or population) develops. This would highlight that it is appropriate to review the Tier A and Tier B areas over time.
- 5.14 This report does not review the appropriateness of the Tier A and B postcodes. Similarly, this report does not review the adequacy of Tier A premium rates, relative to the other Tiers.

### **Summary**

- 5.15 Overall, premiums are adequate in the current market in that they generate an adequate return on capital and support the operation of the fund. However it is impossible to determine if premiums are actuarially adequate to meet the future costs of claims. By their nature, such claims are highly uncertain and there is no statistically credible database against which to test the adequacy of premiums in this manner. Any assessment of the adequacy of premiums remains highly uncertain. It

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<sup>4</sup> APRA Quarterly General Insurance Statistics, March 2018

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also remains dependent on the effectiveness of security forces operating in Australia.

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### 6 Conclusion

- 6.1 Net assets targeted by the ARPC are adequate in that they ensure the ARPC has adequate assets to fund a single material DTI (e.g. \$3 billion). However to continue operating after the first material DTI, the ARPC would need to rebuild capital (supported by the Commonwealth) and may also need to seek immediate support should a second similar incident occur. The ARPC would be more resilient if higher levels of net assets were targeted, in line with the maximum net assets under the CMP.
- 6.2 The ARPC has developed a CMP. This plan sets out minimum, target and maximum levels of capital. Target capital should be reviewed annually by the ARPC and it is expected that it would increase over time, simply due to inflation and growth in the number of buildings to which the pool is exposed. This future growth should be factored into decisions regarding the capital held by ARPC. I suggest that the ARPC's plans should include a target RoE that is sufficient to generate an operating surplus that is not only sufficient to meet its outgoings, but to also generate an amount of retained surplus that will see it meet its capital management policy within a prudent period.
- 6.3 The ARPC is presently operating with net assets below its nominated target capital. It is prudent for an insurer in this position to have a plan to reach their target capital within a reasonable period, for example within three years. The forecast developed for this report suggests that the ARPC is expected to achieve its target capital in this timeframe, subject to the special distribution ceasing and the total of the guarantee fee and the capital holding fee not increasing by more than \$10 million pa.
- 6.1.1 Assuming that the guarantee fee is akin to a layer of retrocession, which is only called upon for claims in excess of \$3.3 billion, suggests that a reasonable fee for the guarantee lies in the range of \$55 million to \$65 million pa. There is considerable judgement in forming this view. It assumes the Commonwealth continues to act as a "benevolent reinsurer" and does not seek to impose a commercial minimum RoL. I believe this approach is reasonable given the distinctly different role of the Commonwealth, compared to a commercial reinsurer.
- 6.4 The capital charge is, in effect, a dividend that is a distribution of a percentage of the annual operating surplus. In order to grow capital to meet the ARPC's target capital, the percentage that is distributed needs to be set at less than 100 per cent. Setting both a target operating surplus (or return on capital) and a percentage that is to be distributed provides a framework for ensuring the ARPC meets its target capital within a prudent period. Examining ARPC's recent financial results, this may not result in a materially different operating result or payment from the current capital charge, but it would make the arrangement more resilient by setting a framework that prompts the forward planning of future capital requirements. As with the guarantee fee there is some judgement in the parameters adopted, however targeting a RoE (operating result) equal to the "cash rate + 10 per cent" and setting

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the percentage at 55 per cent would result in a distribution of \$35 million pa. Setting the percentage at 70 per cent would result in a distribution of \$45 million pa. Setting a percentage in this range would suggest a sustainable expected distribution (being below 100 per cent) and would result (all else being equal) in the ARPC being expected to meet its target capital over a three year period.

- 6.5 Overall, premiums are adequate in the current market in that they generate an adequate return on capital and support the operation of the fund. However it is impossible to determine if premiums are actuarially adequate to meet the future costs of claims. By their nature, these are highly uncertain and there is no statistically credible database against which to test the adequacy of premiums in this manner. Any assessment of the adequacy of premiums remains highly uncertain. It also remains dependent on the effectiveness of security forces operating in Australia.



Guy Thorburn  
Australian Government Actuary

5 November 2018



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### Appendix: Historical & Forecast Cash Flows

To 30 June	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	
\$'000																			
<b>Opening Balance</b>	-	18,164	111,276	220,697	332,010	456,719	551,264	604,460	665,846	360,192	432,642	573,034	537,700	503,677	455,176	425,893	456,614	487,929	
Premium Revenue	18,986	91,321	102,637	96,890	99,944	104,371	105,391	108,720	119,130	127,281	129,708	128,134	126,172	147,208	169,625	178,900	180,669	182,496	
Outwards Retrocession Premium Expense	-	-	-	-	-	-37,440	-80,098	-84,186	-81,607	-81,381	-81,728	-71,249	-63,002	-61,546	-62,369	-66,500	-68,163	-69,867	
Commonwealth Guarantee Fee	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
<b>Net Premium Revenue</b>	18,986	91,321	102,637	96,890	99,944	66,931	25,293	24,534	37,523	45,900	47,980	1,885	8,170	30,662	52,256	57,400	57,527	57,629	
Claims Expenses	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
Retrocession and other recoveries (Revenue)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
<b>Net Claims Incurred</b>	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
Retrocession Commission Income	-	-	-	-	-	3,446	7,551	8,004	7,705	7,471	7,606	6,956	6,118	5,953	5,979	6,000	6,000	6,000	
Acquisition Costs	-198	-532	-930	-412	-452	-599	-603	-609	-1,124	-1,167	-1,089	-1,035	-1,549	-2,072	-1,843	-1,900	-1,948	-1,996	
Other operating expenses	-1,378	-2,467	-3,034	-3,973	-4,353	-5,395	-6,800	-6,635	-6,969	-6,682	-7,962	-6,973	-6,622	-6,291	-6,873	-8,000	-8,313	-8,637	
<b>Underwriting Result</b>	17,410	88,322	98,573	92,505	95,139	64,383	25,441	25,294	37,135	45,522	46,535	833	6,117	28,252	49,519	53,500	53,267	52,996	
Investment Income	532	4,790	10,833	18,803	29,570	30,416	28,351	36,180	40,946	35,912	26,531	21,337	17,230	15,574	13,675	12,221	13,048	13,890	
Other Income	222	-	15	5	-	254	596	88	5,484	4,191	1,660	-	150	176	25	-	-	-	
Finance Charges	-	-	-	-	-	-	-	-	-17	-4,793	-4	-4	-20	-3	-2	-	-	-	
<b>Operating Result before Capital Fees</b>	18,164	93,112	109,421	111,313	124,709	94,545	53,196	61,386	83,548	72,450	71,402	22,166	23,477	43,999	63,217	65,721	66,314	66,885	
Capital Holding Fee	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
Distribution	-	-	-	-	-	-	-	-389,202	-	-	68,990	-57,500	-57,500	-57,500	-57,500	-35,000	-35,000	-35,000	
<b>Net Cash Flow</b>	18,164	93,112	109,421	111,313	124,709	94,545	53,196	61,386	-305,654	72,450	140,392	-35,334	-34,023	-48,501	-29,283	30,721	31,314	31,885	
<b>Closing Balance</b>	18,164	111,276	220,697	332,010	456,719	551,264	604,460	665,846	360,192	432,642	573,034	537,700	503,677	455,176	425,893	456,614	487,929	519,814	
Total Payments to Cwealth	-	-	-	-	-	-	-	-	389,202	-	68,990	112,500	112,500	147,500	147,500	90,000	90,000	90,000	
ROE	-	-	-	-	-	-	-	-	-	-	-	3.8%	4.3%	8.4%	13.0%	14.3%	13.5%	12.8%	
<b>Capital Mgt Plan</b>																			
Minimum Capital														510,000	345,000	353,625	362,466	371,527	
Target Capital														860,000	445,000	456,125	467,528	479,216	
Maximum Capital															780,000	799,500	819,488	839,975	
Actual Capital	18,164	111,276	220,697	332,010	456,719	551,264	604,460	665,846	360,192	432,642	573,034	537,700	503,677	455,176	425,893	456,614	487,929	519,814	

Key assumptions underpinning the forecast are:

- Premium revenue in 2019 is assumed to equal the gross written premium in 2018 and increase by 1 per cent pa thereafter.

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- Retrocession premiums are assumed to increase by \$3.5 million pa in 2019 to provide some capacity to bring additional reinsurers into the market. Assumed increases at 2.5 per cent pa thereafter.
- Commonwealth guarantee fee is assumed to remain at \$55 million pa and the capital holding fee is assumed to remain at \$35 million pa.
- Retrocession commission income is assumed to remain broadly in line with recent experience
- Acquisition costs are assumed to remain broadly in line with recent experience in 2019, then increasing at 2.5 per cent pa
- Other operating expenses are assumed to increase by \$1.0 million pa on 2019 to provide for additional projects and then for the wage component to increase by 5 per cent pa and other costs to increase by 2.5 per cent pa.
- Investment income is assumed to be earned at the rate of 2.7 per cent of average net assets (which compares to 2.8 per cent in 2018).

# ANNEX C: TERRORISM COVERAGE FOR PERSONAL HARM IN AUSTRALIA

## Government schemes

### Workers' compensation

Governments will pay out for workers' compensation liabilities arising from a terrorist incident.<sup>20</sup> There are no terrorism exclusions for workers' compensation in any jurisdiction (see Table C.1), but cover varies between jurisdictions.

**TABLE C.1: THERE IS NO GAP IN COVERAGE OF TERRORISM RISK BETWEEN WORKERS' COMPENSATION SCHEMES**

Jurisdiction	Underwriting	Terrorism cover?	How is terrorism covered?
NSW	State, with some exceptions in particular industries	Yes	There are no exclusions for people who suffer work-related injury or illness as a result of a terrorist act. If an insurer incurs significant liability from a declared act of terrorism, they may formally request that the Minister activate the Terrorism Re-insurance Fund. <sup>21</sup>
VIC	State, with claims management outsourced to appointed private providers	Yes	There is no exclusion for injury or death sustained as a result of a terrorist incident. Claims are assessed according to the Act and a range of other factors, including: whether the claimant is a 'worker' under the <i>Workplace Injury Rehabilitation and Compensation Act 2013</i> (VIC); whether the employment is connected with Victoria; and whether the injury or death has arisen out of or in the course of employment. <sup>22</sup>
ACT	Private	Yes	Insurers must pay out, but may be reimbursed by the Terrorism Cover Temporary Reinsurance Fund. <sup>23</sup>
WA	Private	Yes, up to \$25M	Appointed insurers may write terrorism risk out of insurance policies. The State government assumes the risk up to \$25 million, after which a reduction percentage applies if the Minister has made an order. <sup>24</sup> An insurer may not exclude liability for terrorism from its policy unless it has received permission in writing from WorkCoverWA, which will not be given unless it is satisfied that the liability is attributable to an act of terrorism. <sup>25</sup>

20 However, the WA and TAS governments limit their liability to \$25 million, see *Workers' Compensation and Injury Management (Acts of Terrorism) Act 2001* (WA), s8(3)(b); *Workers Compensation Act 1951* (ACT), s179D; *Workers Rehabilitation and Compensation Act 1988* (TAS), s131C.

Licensed self-insurers must also pay out for terrorism-related liabilities, and generally cannot reinsure this risk.

21 Advice given by State Insurance Regulatory Authority (NSW), 4 October 2018.

22 Advice given by Worksafe Victoria, September 2018.

23 *Workers Compensation Act 1951* (ACT), ss 179D and 179E.

24 *Workers' Compensation and Injury Management (Acts of Terrorism) Act 2001*, s8.

25 *Workers' Compensation and Injury Management (Acts of Terrorism) Act 2001*, s4.

**TABLE C.1: THERE IS NO GAP IN COVERAGE OF TERRORISM RISK BETWEEN WORKERS' COMPENSATION SCHEMES (CONTINUED)**

Jurisdiction	Underwriting	Terrorism cover?	How is terrorism covered?
SA	State, with two private claims agents	Yes	There is no exclusion for injury arising from a terrorist attack under the Return to Work Scheme; the same worker benefits apply, subject to the injury meeting the tests for the injury arising from employment. <sup>26</sup>
TAS	Private	Yes, up to \$25M	The Minister may make an order that a terrorist event has occurred, claims are then to be made on the nominal insurer. The nominal insurer will meet claims up to \$25M after which a reduction percentage applies to limit total liability to \$25M. <sup>27</sup>
QLD	State	Yes	Queensland workers are entitled to apply for compensation if they sustain an injury within the definition of s32 of the Act, which may extend to injury or death arising from terrorist incidents where there is a sufficient connection between the injury or death as a result of the terrorist incident and the duties or requirements of the worker's employment. <sup>28</sup>
NT	Private	Yes	There is no exclusion for terrorism, war or similar under insurance protection given to employers in accordance with statutory policy wording in Schedule 3 of the Regulations. The NT Government undertakes to indemnify insurers in the event of claims liabilities due to a terrorist incident. Self-insurers are not given an indemnity, but must pay out for work-related injuries caused by a terrorist incident. <sup>29</sup>
Cth (Comcare)	Commonwealth	Yes	There are no specific exclusions for terrorism. Licensees also do not have the ability to exclude for terrorism incidents. An injury will be treated as arising out of or in the course of employment if it was sustained as a result of an act of violence that would not have occurred but for the employee's employment or the performance of their duties or functions of their employment. <sup>30</sup>

In most jurisdictions, the basis for a worker's entitlement to compensation is they have sustained an injury arising 'out of or in the course of employment'.<sup>31</sup>

26 ReturnToWorkSA, advice given September 2018.

27 Workers' Rehabilitation and Compensation Act 1988 (TAS), ss 131B and 131C.

28 Advice given by Office of Industrial Relations, 3 October 2018.

29 Advice given by NT WorkSafe, September 2018.

30 Advice given by Comcare, September 2018.

31 *Workplace Injury Rehabilitation and Compensation Act 2013* (Vic), s5, s39(1); *Workers' Rehabilitation and Compensation Act 1988* (TAS), s25(1)(a); *Workers Compensation Act 1987* (NSW), s4; *Return to Work Act* (NT), s4; *Workers Compensation Act 1951* (ACT), s31; *Workers' Compensation and Rehabilitation Act 2003* (QLD), s5(1), s32, 33; *Workers' Compensation and Injury Management Act 1981* (WA), s19. Cf – the narrower drafting in the South Australian *Return to Work Act 2014* (SA), s7(1): "This Act applies to an injury if (and only if) it arises from employment" (emphasis added).

The different workers' compensation schemes do not cover workers in all circumstances, particularly if a worker is injured or killed off the work premises. If an individual is injured on a work break or on their way to or from work, they will not have the right to claim compensation under all workers' compensation schemes. Schemes in Victoria, Western Australia, Tasmania, the Northern Territory, Comcare and to a lesser extent New South Wales, generally do not allow claims for injuries sustained on the way to or from work (Table C.2). For example, these workers could not claim if there were a terrorism incident on their commute to work. The South Australian and Tasmanian schemes do not allow claims for injuries sustained during breaks from work off the work premises. For example, South Australian and Tasmanian workers could not claim if they were injured by in a terrorism incident while they took a coffee break in a nearby café.

**TABLE C.2: COVERAGE OF JOURNEYS AND BREAKS (WORKERS' COMPENSATION)<sup>32</sup>**

	Journeys to and from work	Work-related travel	Breaks – offsite
<b>NSW</b>	Yes, for certain exempt workers. For all other workers with injuries received on or after 19 June 2012, there must be a real and substantial connection between the employment and the accident or incident out of which the injury arose – s10 and Schedule 6 Part 19H, clause 18, 1987 Act.	Yes – s4, 1998 Act	Yes – s11, 1987 Act
<b>VIC</b>	No – s46	Yes, some restrictions – s46	Yes – s46
<b>QLD</b>	Yes, some restrictions – s35	Yes – s34	Yes – s34(1)(c)
<b>WA</b>	No – s19(2)	Yes – s19(1)	No reference in the Act. Coverage depends on factual circumstances or common law.
<b>SA</b>	Yes, but limited – s7(8)(b)	Yes – s7(8)(a)	No
<b>TAS</b>	No, some exceptions – s25(6)	Yes – s25(6)	No, some exceptions – s25(6)
<b>NT</b>	No, some exceptions – s4 & r 5AA	Yes, s4	Yes, some exceptions (injury from MVA) – s4
<b>ACT</b>	Yes – s36	Yes – s36	No reference
<b>C'wealth Comcare</b>	No, some exceptions – s6(1C)	Yes – s6(1)(d)	Yes, since 7 December 2011 ('ordinary recess')

## Victims of crime assistance schemes

Victims of crime assistance schemes extend to terrorist incidents and offer varying maximum amounts of compensation and assistance between jurisdictions (Table C.3). Eligibility requirements also differ—primary victims may claim in all States and Territories, while Victoria, New South Wales, Queensland and Tasmania also offer compensation to secondary and related victims of violent crimes.<sup>33</sup> An individual will generally have their victims of crime compensation reduced if they have received (or are entitled to receive) another payment, such as workers' compensation.

32 Source for table – Safe Work Australia, Comparison of Workers' Compensation Arrangements in Australia and New Zealand, 2017, p 27-28.

33 Secondary victims, generally, are persons who witness a violent crime, while related victims are family members, spouses, children or partners of the deceased primary victim.

**TABLE C.3: AMOUNTS AND ENTITLEMENT TO COMPENSATION UNDER VICTIMS OF CRIME ASSISTANCE SCHEMES**

State	Who may claim	Compensation offered
<b>Victoria</b>	Primary victims Secondary victims Related victims (if primary victim is dead)	Cap on payment to primary victim - \$60,000, plus additional special financial assistance up to \$10,000. <sup>34</sup> Cap on payment to secondary victim - \$50,000, plus additional reasonable expenses in exceptional circumstances if the secondary victim was under 18 years. <sup>35</sup> Maximum amount per death paid out to related victims - \$100,000. <sup>36</sup> If the applicant has received a workers' compensation or CTP payment, this must be taken into account and the compensation reduced by the amount received under either (or both) schemes. <sup>37</sup>
<b>NSW</b>	Primary victims Secondary victims Immediate family victims (if the primary victim has died as a result of the crime) <sup>38</sup>	Immediate financial assistance to primary victims is capped at \$5,000. <sup>39</sup> Funeral costs if the primary victim dies are capped at \$8,000. <sup>40</sup> Cap on financial assistance for economic loss (primary victim) - \$30,000. <sup>41</sup> Cap on 'recognition' payment (an amount paid in recognition of the applicant's loss) if financially dependent on deceased victim - \$15,000. <sup>42</sup> If the applicant may be entitled to workers' compensation, their victims of crime compensation determination will be postponed until their workers' compensation application is finalised. <sup>43</sup> Compensation paid under any other scheme (including workers' compensation) is taken into account when determining the compensation amount. <sup>44</sup>

34 *Victims of Crime Assistance Act 1996 (Vic)*, ss 8 and 8A.

35 *Victims of Crime Assistance Act 1996 (Vic)*, ss 9, 10 and 10A.

36 *Victims of Crime Assistance Act 1996 (Vic)*, s12(1).

37 *Victims of Crime Assistance Act 1996 (Vic)*, s16.

38 *Victims Rights and Support Act 2013 (NSW)*, s5.

39 *Victims Rights and Support Regulations 2013 (NSW)*, r 8(1).

40 *Victims Rights and Support Regulations 2013 (NSW)*, r 11.

41 *Victims Rights and Support Regulations 2013 (NSW)*, r 8.

42 *Victims Rights and Support Regulations 2013 (NSW)*, r 12.

43 *Victims Rights and Support Act 2013 (NSW)*, s44(5).

44 *Victims Rights and Support Act 2013 (NSW)*, s44(4).

**TABLE C.3: AMOUNTS AND ENTITLEMENT TO COMPENSATION UNDER VICTIMS OF CRIME ASSISTANCE SCHEMES (CONTINUED)**

State	Who may claim	Compensation offered
<b>QLD</b>	<p>Primary victims</p> <p>Secondary victims, including parent secondary victim and witness secondary victims</p> <p>Related victims (close family members or dependants of primary victim who has died as a result of act).<sup>45</sup></p> <p>Persons must apply for a workers' compensation payment before applying for victims of crime assistance, subject to some exceptions.<sup>46</sup></p>	<p>Cap on payment to primary victim - \$75,000.<sup>47</sup></p> <p>Cap on payment to secondary victim - \$50,000.<sup>48</sup></p> <p>Cap on total amount given to related victims of an act of violence - \$100,000.<sup>49</sup></p>
<b>SA</b>	<p>Immediate (primary) victims of the offence.<sup>50</sup></p> <p>Where the primary victim has died as a result of the offence, their spouse or domestic partner, child (if under 18) or parent (if victim is a child) may claim compensation for grief.<sup>51</sup></p> <p>Dependants of the deceased victim may claim for financial loss.<sup>52</sup></p> <p>A person is not entitled to compensation if they have received or are entitled to receive: a workers' compensation payment; payment from a compulsory third party insurance scheme; or hospital or medical expenses recoverable from a health fund.<sup>53</sup></p>	<p>Cap on compensation for non-financial loss (for victim) - \$100,000.<sup>54</sup></p> <p>Cap on compensation for financial loss (for victim or victim's dependant if deceased) - \$2,000 + 75% of excess of first \$2,000 lost, capped at \$100,000.<sup>55</sup></p> <p>Aggregate compensation for non-financial and financial loss must not exceed \$100,000.<sup>56</sup></p>
<b>WA</b>	<p>Primary victims may claim compensation for injury and loss</p> <p>If the victim dies as a result of the offence, their close relatives may claim compensation if they have suffered loss as a result of the victim's death.<sup>57</sup></p>	<p>Cap on payment to victim or close relative if deceased - \$75,000.<sup>58</sup></p> <p>Any amounts already or likely to be received by way of compensation (under a different scheme) or damages will be deducted from the award under the Act.<sup>59</sup></p>

45 *Victims of Crime Assistance Act 2009 (QLD)*, s26(5).

46 *Victims of Crime Assistance Act 2009 (QLD)*, s34.

47 *Victims of Crime Assistance Act 2009 (QLD)*, s38.

48 *Victims of Crime Assistance Act 2009 (QLD)*, s41 and 44.

49 *Victims of Crime Assistance Act 2009 (QLD)*, s48.

50 *Victims of Crime Act 2001 (SA)*, s17(1).

51 *Victims of Crime Act 2001 (SA)*, s17(2).

52 *Victims of Crime Act 2001 (SA)*, s17(3).

53 *Victims of Crime Act 2001 (SA)*, s17(5).

54 *Victims of Crime Act 2001 (SA)*, ss 20(1)(a) and 20(3)(a).

55 *Victims of Crime Act 2001 (SA)*, ss 20(1)(b) and 20(3)(a).

56 *Victims of Crime Act 2001 (SA)*, s20(3)(c).

57 *Criminal Injuries Compensation Act 2003 (WA)*, s12.

58 *Criminal Injuries Compensation Act 2003 (WA)*, s31(1).

59 *Criminal Injuries Compensation Act 2003 (WA)*, s42(3) and (4).

**TABLE C.3: AMOUNTS AND ENTITLEMENT TO COMPENSATION UNDER VICTIMS OF CRIME ASSISTANCE SCHEMES (CONTINUED)**

State	Who may claim	Compensation offered
<b>TAS</b>	Primary victims Secondary victims (witnesses and parents of primary victims who were under 18) Related victims <sup>60</sup>	Cap on payment to primary victim - \$30,000. Cap on payment to secondary victim - \$20,000. Cap on payment to relation - \$10,000 (limit on multiple related claims - \$50,000). <sup>61</sup> Compensation will not be awarded if workers' compensation has already been paid. <sup>62</sup>
<b>ACT</b>	Primary victims Related victims, including financial dependants who are close family members or intimate partners (Class A); close family members or intimate partners who are not financially dependent on the victim (Class B); and family members who are financial independent of the primary victim (Class C) Homicide witnesses <sup>63</sup>	Cap on payment to primary victim - \$50,000. Class A related victim - \$30,000. Class B related victim - \$20,000. Class C related victim - \$10,000. Homicide witness - \$10,000. <sup>64</sup> If the applicant has received a workers' compensation payment, the amount of financial assistance must be reduced by that amount. <sup>65</sup>
<b>NT</b>	Primary victims Secondary victims, including witnesses, children or stepchildren of primary victims, and parent, step-parents or guardians of the primary victim if they are a child. Family victims, including financial dependents of the primary victim. Related victims, including intimate partners. <sup>66</sup>	Cap on payment to primary victim - \$40,000 for non-financial loss and \$10,000 for financial loss. <sup>67</sup> Cap on payment to secondary victims - \$40,000 and \$10,000 for non-financial and financial loss, respectively. <sup>68</sup> Cap on payment to family victims - \$40,000 and \$10,000 for non-financial and financial loss, respectively. <sup>69</sup> Related victims are eligible to apply for counselling. <sup>70</sup> Applicants who are entitled to a benefit under the CTP or workers' compensation scheme are not eligible to apply for financial assistance as a primary victim in respect of the same injury, but may apply for counselling. <sup>71</sup>

60 *Victims of Crime Assistance Act 1976 (TAS)*, s2(1) – definition.

61 *Victims of Crime Assistance Act 1976 (TAS)*, s6A and prescribed maximums available: [http://www.justice.tas.gov.au/victims/financialassistance/awards\\_and\\_payments](http://www.justice.tas.gov.au/victims/financialassistance/awards_and_payments).

62 *Victims of Crime Assistance Act 1976 (TAS)*, s6(1)(d) and (2).

63 *Victims of Crime (Financial Assistance) Act 2016 (ACT)*, ss 19-23.

64 *Victims of Crime (Financial Assistance) Regulations 2016 (ACT)*, r 5.

65 *Victims of Crime (Financial Assistance) Act 2016 (ACT)*, s47(1)(a). 'Associated payment' includes a workers' compensation payment.

66 *Victims of Crime Assistance Act (NT)*, ss 9-16.

67 *Victims of Crime Assistance Act (NT)*, s38.

68 *Victims of Crime Assistance Act (NT)*, s39.

69 *Victims of Crime Assistance Act (NT)*, s40.

70 *Victims of Crime Assistance Act (NT)*, s16.

71 *Victims of Crime Assistance Act (NT)*, s17.



## Compulsory third party insurance (CTP) and National Injury Insurance Scheme (NIIS)

All States and Territories, except for Victoria and Western Australia, exclude terrorism from their CTP schemes (Table C.4).<sup>72</sup>

In Victoria, the ACT and South Australia, people catastrophically injured as a direct result of a car being driven in order to commit a terrorist act could claim on the NIIS for lifetime care and support. Workers in all jurisdictions (subject to Tasmania and Western Australia implementing the NIIS workplace accidents stream) may also be eligible if they suffer a catastrophic terrorism-related workplace injury.

The NIIS is a no-fault scheme to provide lifetime care and support to people who suffer a 'catastrophic injury' (as distinct from any personal injury) as a result of: motor vehicle accidents; workplace accidents; medical accidents; and general accidents.<sup>73</sup>

People who suffer a catastrophic injury may access any support that is 'reasonable and necessary', which includes the immediate medical costs of treating their injury and ongoing costs of living with the disability.<sup>74</sup>

**TABLE C.4: TERRORISM COVERAGE IS INCONSISTENT ACROSS CTP SCHEMES AND THE NIIS**

Jurisdiction	Fault (CTP)	CTP legislation	Terrorism exclusion in CTP?	NIIS legislation	Terrorism exclusion in NIIS?
NT	No fault	<i>Motor Accidents (Compensation) Act 2017 (NT)</i>	Yes, s10C	<i>Motor Accidents (Compensation) Act 2017 (NT)</i>	Yes, s10C
NSW	No fault	<i>Motor Accidents Compensation Act 1999 (NSW)</i>	Yes, s15A	<i>Motor Accidents Compensation Act 1999 (NSW)</i>	Yes, s15A
TAS	No fault	<i>Motor Accidents (Liabilities and Compensation) Act 1973 (TAS)</i>	Yes, s14(4)(c)	<i>Motor Accidents (Liabilities and Compensation) Act 1973 (TAS)</i>	Yes, s14(4)(c)
VIC	No fault	<i>Transport Accident Act 1986 (Vic)</i>	No	<i>Transport Accident Act 1986 (Vic)</i>	No
QLD	Fault based	<i>Motor Accident Insurance Act 1994 (QLD)</i>	Yes, s5(4)	<i>National Injury Insurance Scheme (Queensland) Act 2016 (QLD)</i>	Yes, s4(3)(b)
WA	Fault based	<i>Motor Vehicle (Third-party compensation) Act 1943 (WA)</i>	No	<i>Motor Vehicle (Catastrophic Injuries) Act 2016 (WA)</i>	Yes, s5(5)(b)

72 *Motor Accidents Compensation Act 1999 No 41 (NSW), s15A; Road Transport (Third-Party Insurance) Act 2008 (ACT), s22(1)(c); Motor Vehicles Act 1959 (SA), s99(3a); Motor Accidents (Liabilities and Compensation) Act 1973 (TAS), s14(4)(c); Motor Accident Insurance Act 1994 (QLD), s5(4)(5) and (6); Motor Accidents (Compensation) Act 2017 (NT), s10C.*

73 Regulation Impact Statement, National Injury Insurance Scheme: Motor Vehicle Accidents, June 2014, p 3. The NIIS Motor Vehicle Accidents stream has been implemented in all States and Territories. All except WA and TAS have implemented the Workplace Accidents stream. The definition of 'catastrophic injury' is in the Heads of Agreement between the Commonwealth and State and Territory governments, available: <https://www.ndis.gov.au/search/?text=heads-of-agreement>.

74 Regulation Impact Statement, National Injury Insurance Scheme: Motor Vehicle Accidents, June 2014, p 16.

**TABLE C.4: TERRORISM COVERAGE IS INCONSISTENT ACROSS CTP SCHEMES AND THE NIIS (CONTINUED)**

Jurisdiction	Fault (CTP)	CTP legislation	Terrorism exclusion in CTP?	NIIS legislation	Terrorism exclusion in NIIS?
ACT	Fault based	<i>Road Transport (Third-Party Insurance) Act 2008 (ACT)</i>	Yes, s22(1)(c)	<i>Lifetime Care and Support (Catastrophic Injuries) Act 2014 (ACT)</i>	No
SA	Fault based	<i>Motor Vehicles Act 1959 (SA)</i>	Yes, s99(3a)	<i>Motor Vehicle Accidents (Lifetime Support Scheme) Act 2013 (SA)</i>	No

To date, the NIIS has been implemented for motor vehicle accidents and workplace accidents. People catastrophically injured in terrorist incidents in all States and Territories (except Tasmania and Western Australia) may claim on the workplace accidents stream, as long as their injury was sustained 'at work'. The motor vehicle accidents stream is only available for injuries caused by a terrorist incident in Victoria, the ACT and South Australia.

Terrorism is consistently covered across workers' compensation schemes and the NIIS (Table C.5). No legislation implementing the NIIS workplace accidents stream excludes coverage for terrorist incidents. However, at the time of writing, the Tasmanian and Western Australian governments have not yet implemented the NIIS workplace accidents stream.

**TABLE C.5: COVERAGE OF TERRORISM IS CONSISTENT BETWEEN WORKERS' COMPENSATION SCHEMES AND NIIS**

Jurisdiction	Workers' compensation legislation	Terrorism coverage under WC?	NIIS legislation	Terrorism exclusion under NIIS?
QLD	<i>Workers Compensation and Rehabilitation Act 2003 (QLD)</i>	Yes (see Table 4.1)	<i>Workers Compensation and Rehabilitation (National Injury Insurance Scheme) Amendment Act 2016</i>	No
VIC	<i>Workers Injury Rehabilitation and Compensation Act 2013 (VIC)</i>	Yes (see Table 4.1)	<i>Workers Injury Rehabilitation and Compensation Act 2013 (VIC)</i> <sup>75</sup>	No
NSW	<i>Workers Compensation Act 1987 (NSW) and Workplace Injury Management and Workers Compensation Act 1998 (NSW)</i>	Yes (see Table 4.1)	<i>Workers Compensation Act 1987 (NSW) and Workplace Injury Management and Workers Compensation Act 1998 (NSW)</i> <sup>76</sup>	No
SA	<i>Return to Work Act 2014 (SA)</i>	Yes (see Table 4.1)	<i>Return to Work Act 2014, s176 &amp; Motor Vehicle Accidents (Lifetime Support Scheme) Act 2013, s55</i>	No <sup>77</sup>

75 These arrangements were considered to satisfy the minimum benchmark for workplace accidents; see Heads of Agreement Commonwealth and Victorian Governments on the National Disability Insurance Scheme agreed 4 May 2013, clause 38.

76 These arrangements were considered to satisfy the minimum benchmarks for workplace accidents; see Heads of Agreement Commonwealth and New South Wales Governments on the National Disability Insurance Scheme agreed 6 December 2012, clause 40.

77 The SA Work Cover authority may enter into agreement with Lifetime Support Scheme authority where they believe a person under WC scheme would benefit from accessing the LSS scheme. There is no terrorism exclusion in either Act.

**TABLE C.5: COVERAGE OF TERRORISM IS CONSISTENT BETWEEN WORKERS' COMPENSATION SCHEMES AND NIIS (CONTINUED)**

Jurisdiction	Workers' compensation legislation	Terrorism coverage under WC?	NIIS legislation	Terrorism exclusion under NIIS?
ACT	<i>Workers Compensation Act 1951 (ACT)</i>	Yes(see Table 4.1)	<i>Lifetime Care and Support (Catastrophic Injuries) Act 2014</i>	No
NT	<i>Return to Work Act (NT)</i>	Yes (see Table 4.1)	<i>Return to Work Act (NT)</i>	No
TAS	<i>Workers' Rehabilitation and Compensation Act 1988 (TAS)</i>	Yes, up to \$25M (see Table 4.1)	Not yet implemented	N/A
WA	<i>Workers' Compensation and Injury Management Act 1981 (WA)</i>	Yes, up to \$25M (see Table 4.1)	Not yet implemented	N/A

By contrast, terrorism is inconsistently covered across the CTP and NIIS motor vehicle injury schemes in most jurisdictions. As the NIIS is no-fault, the States and Territories with fault-based CTP schemes passed separate legislation to implement the NIIS minimum benchmarks. This could have contributed to inconsistency of terrorism coverage between CTP and NIIS in some cases.

### National Disability Insurance Scheme (NDIS)

Individuals under 65 years of age who are seriously and permanently disabled as a result of an injury sustained in a terrorist attack may claim on the NDIS if they are not eligible for the NIIS.

The NDIS will cover the ongoing costs of living with the disability the injury causes, but will not cover the immediate medical and rehabilitation costs associated with the injury. There is also some scope for an individual to claim for early intervention in a condition that could become permanent.<sup>78</sup>

### Commercial insurance products

#### Private health insurance

Individuals injured in a terrorist incident will be able to claim on their private health insurance policy for medical expenses. Private health insurance policies do not generally exclude coverage for terrorism.

#### Public liability insurance

Provided the insured incurs a liability and a terrorist incident is declared under the *Terrorism Insurance Act 2003*, an injured person will have recourse to a building owners' public liability insurance. Public liability insurance is an eligible insurance contract under the *Terrorism Insurance Act 2003*;<sup>79</sup> reinsurance for terrorism-related public liability insurance is available through the ARPC. Most public liability insurance policies contain terrorism exclusion clauses, but these will be overridden in the event of a declared terrorism incident.

<sup>78</sup> Eligibility requirements for the NDIS and the scope of coverage are available at: [www.ndis.gov.au](http://www.ndis.gov.au).

<sup>79</sup> *Terrorism Insurance Act 2003* (Cth), s7(1)(c).

## Group life insurance

Individuals who hold group life insurance policies have a reasonable likelihood of claiming a benefit if they are seriously injured or killed in a terrorist incident.

As outlined in Chapter 4, approximately 12 million individuals in Australia hold some kind of life insurance in their superannuation. The most common type of insurance held through superannuation is term life insurance or ‘death cover’, being a set amount paid out when the individual dies. Of the 15.4 million MySuper accounts in Australia at June 2017, 75 per cent had term life insurance policies, followed by Total and Permanent Disability benefits (TPD, 67 per cent) and then income protection benefits (29 per cent).<sup>80</sup>

No group life insurance guide surveyed as part of this review contained an explicit terrorism exclusion clause (Table C.6).

In the course of consultation, a question was posed as to whether exclusions in life policies for ‘war’ and ‘warlike activity’ would also extend to terrorism.

This review considers it is unlikely that an exclusion for war or warlike activity would prevent a life insured claiming a benefit purely because the event giving rise to their claim was an act of terrorism. It is not possible to generalise that an act of terrorism will be excluded because of an exclusion for warlike activity. However, whether these exclusions apply at all to terrorism is largely untested in the life insurance context in Australia.

There are no life insurance industry standard definitions for war, warlike activity or terrorism. Definitions of war and warlike activity are inconsistent across the market (Table C.6). A number of group life policies excluded cover for war without defining the term in the life insurance guide. Two group life insurers (TAL Life Limited and AMP Life Limited) defined ‘war’ as ‘includes but not limited to war (whether declared or not) or war related activities, revolution, invasion, rebellion or civil unrest.’ This was the most detailed war definition—others were expressed in broader terms such as ‘any war or act of war’.

**TABLE C.6: MAJOR GROUP LIFE INSURANCE GUIDES SURVEYED DID NOT CONTAIN TERRORISM EXCLUSIONS<sup>81</sup>**

Rank	Fund	Member accounts	Group life insurer	Explicit terrorism exclusion	War exclusion
1	AustralianSuper Not for profit	2,154,630	TAL Life Limited	None	No war exclusion for death or total and permanent disability (TPD). War is excluded for income protection cover. War definition: includes any act of war (whether declared or not), revolution, invasion, rebellion or civil unrest. <sup>82</sup>

80 Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness*, draft report, April 2018, p 316.

81 Source for funds and member account numbers: APRA, *Annual Fund-Level Superannuation Statistics*, June 2017.

82 AustralianSuper, ‘Insurance in your super: Money when it matters most’, group life insurance guide effective 26 May 2018, p 30.

**TABLE C.6: MAJOR GROUP LIFE INSURANCE GUIDES SURVEYED DID NOT CONTAIN TERRORISM EXCLUSIONS (CONTINUED)**

Rank	Fund	Member accounts	Group life insurer	Explicit terrorism exclusion	War exclusion
2	Retail Employees Superannuation Trust Not for profit	1,981,539	AIA Australia Limited	None	None <sup>83</sup>
3	AMP Superannuation Savings Trust For profit Includes multiple super products	1,892,157	AMP Life Limited <sup>84</sup>	None	<p>War is not excluded for death, accidental death, terminal illness or TPD cover if the act of war occurred in Australia.</p> <p>War is only excluded for death, accidental death, terminal illness or TPD caused by an act of war <b>while insured was working overseas for the purposes of their employer.</b></p> <p>War is excluded on group salary continuance (income protection) if the person insured's total or partial disability, listed specific sickness or specific injury was caused by an act of war.</p> <p>Definition of war: includes but not limited to war (declared or undeclared) or war related activities, revolution, invasion or rebellion or civil unrest.<sup>85</sup></p>
4	MLC Super Fund For profit Includes multiple super products	1,244,420	MLC Limited	None	War is excluded on income protection for disability due to the insured's involvement in war or any act of war. <sup>86</sup>
5	Hostplus Superannuation Fund Not for profit	1,199,299	MetLife Insurance Limited	None	<p>War is excluded for death &amp; TPD if the event giving rise to the claim is any war or act of war as defined in the insurance policy.</p> <p>War is excluded for salary continuance for any war or act of war as defined in the insurance policy<sup>87</sup></p>

83 REST, 'REST Super Insurance Guide' group life insurance guide effective 4 April 2018.

84 AMP Limited announced the sale of AMP Life Limited on 25 October 2018.

85 AMP, 'Group Insurance', product disclosure statement issued 10 October 2017, pp 13, 40.

86 MLC, 'MLC MasterKey Super & Pension Fundamentals', product disclosure statement issued 1 October 2018, p 13; MLC, 'MLC MasterKey Business Super', product disclosure statement issued 1 October 2018, p 7.

87 Hostplus, 'Insurance in your super', group life insurance guide issued 29 August 2018.

**TABLE C.6: MAJOR GROUP LIFE INSURANCE GUIDES SURVEYED DID NOT CONTAIN TERRORISM EXCLUSIONS (CONTINUED)**

Rank	Fund	Member accounts	Group life insurer	Explicit terrorism exclusion	War exclusion
6	Sunsuper Superannuation Fund Not for profit	1,162,228	AIA Australia Limited	None	None <sup>88</sup>
7	RetirementWrap For profit Includes multiple super products	953,145	Westpac Life Insurance Services Ltd & AIA Australia Ltd (for BT Lifetime Super employer fund before 31 December 2017).	None	General exclusion for war, except for the Death Benefit where the insured person dies on war service. Definition of war: War (whether declared or not). <sup>89</sup>
8	OnePath Masterfund For profit Includes multiple super products	949,486	OnePath Life Ltd (agreement with OnePath Custodians Pty Ltd as trustee of Masterfund to provide benefits through OneCare Super).	None	War is excluded on income secure cover for anything that happens to the life insured in war. War is excluded on living expense cover and business expense cover for anything that happens to the life insured in war. The war exclusion does not apply to the death benefit. 'War' is not defined. <sup>90</sup>
9	Health Employees Superannuation Trust Australia Not for profit	854,011	AIA Australia Limited	None	War is excluded on the death benefit for war or an act of war outside Australia (except if the insured dies on war service). War is excluded for TPD for an act of war outside Australia. War is excluded on income protection for claims caused directly or indirectly by any war or act of war. <sup>91</sup>

88 Sunsuper, 'Sunsuper for life insurance guide', group life insurance guide issued 1 July 2018.

89 BT Insurance, 'BT Protection Plans', product disclosure statement updated 28 August 2018, p 66.

90 OneCare Super, 'Protection for Life', product disclosure statement issued 19 August 2017, p 17-18.

91 HESTA, 'Insurance options to protect you and your family', group life insurance guide issued 1 October 2018, p 10, 15, 19, 32.