Terrorism Insurance Act Review: 2012

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LIST OF ACRONYMS AND ABBREVIATIONS

AGA	Australian Government Actuary
ARPC	Australian Reinsurance Pool Corporation
CBD	Central Business District
DKK	Danish Kroner
DTI	Declared Terrorist Incident as defined in the *Terrorism Insurance Act 2003*
GFC	Global Financial Crisis
ISR	Industrial Special Risks insurance
OECD	Organisation for Economic Co-operation and Development
NBC	Nuclear, biological and chemical risks
NBCR	Nuclear, biological, chemical and radiological risks

EXECUTIVE SUMMARY

AUSTRALIA'S TERRORISM INSURANCE SCHEME

Introduction of the scheme

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

In May 2002, the Government announced that it would act to protect the Australian economy from the negative effects of the withdrawal of terrorism insurance cover. Subsequently, the 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.

Need for the Act to continue

The scheme was established as an interim measure and is intended to operate only while terrorism insurance cover is unavailable commercially on reasonable terms. At the time it was established, the Government also considered that uncertainty in the market made it impossible to stipulate the details or timing of its windup.[1] As a result, the Act requires that at least once every three years, the Minister must prepare a report that reviews the need for the Act to continue in operation.[2]

The 2006 and the 2009 Reviews concluded there was insufficient commercial market terrorism insurance available at affordable rates and that the arrangements should continue to operate, subject to a further review within three years, as stipulated in the Act.

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1 *Terrorism Insurance Bill 2003, Revised Explanatory Memorandum*, para 1.8, p 2.
2 *Terrorism Insurance Act 2003*, section 41.

Consistent with the 2006 and 2009 Reviews, the 2012 Review undertook targeted consultations with a range of stakeholders, including: reinsurers and specialist reinsurance brokers; peak bodies representing the general insurance, banking, broking and property industries; State and Territory governments; and other Australian government agencies, including the ARPC. A consultation paper was distributed to each stakeholder and submissions sought in response to the questions raised in the paper. Ten submissions were received and eight face-to-face consultations and five teleconferences were held. The consultation paper for the 2012 Review is at Appendix C.

The 2012 Review considers the need for the Act to continue in the context of the Australian and international terrorism insurance market. 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.

This Review therefore recommends that the Act continue in operation, and subject to the Government's agreement to this recommendation, that a further review within three years be undertaken, at which time further examination of the availability of commercial terrorism reinsurance on reasonable terms be undertaken.

This Review also notes that the scheme has been backed by a Commonwealth guarantee of the ARPC's liabilities to the amount of $10 billion, for which the Commonwealth has to date not received any form of compensation. No compensation has been required to date as the ARPC was directed to build a pool of reserved funds of $300 million, and later entered into a retrocession program which it has subsequently renewed on an annual basis. This Review recommends that the ARPC pay an initial dividend to the Commonwealth of $400 million, to be spread over four years, with the first payment to be made in January 2013, and that the question of the frequency and amount of any further dividends beyond 2016 be considered in the context of the next review of the Act.

The ARPC has confirmed that the payment of a dividend of this size spread appropriately over four years would not have an impact on the schemes day-to-day operations. A first payment in January 2013 would give the ARPC sufficient time to adjust its reserved funds and make arrangements for its retrocession program for 2013.

Recommendations

This Review makes a number of recommendations:

- **Need for the Act to continue** — that the Act continue in operation, subject to a further review within three years, at which time an examination of the availability of commercial terrorism reinsurance on reasonable terms be undertaken;
- **Premiums** — that the ARPC's current pricing policy remain unchanged;
- **Retentions** — that the ARPC's current industry and individual insurer retention levels remain unchanged;
- **Size of the Scheme** — that an assessment of the appropriate capacity of the scheme should be undertaken as part of the next review of the Act, taking into consideration the size of the government guarantee and any retrocession purchased by the ARPC, as well as the level of the ARPC's exposure to risk;
- that the next review of the Act should reassess the continuing need for, and cost benefit of, the ARPC's retrocession program in the context of the review of the capacity of the scheme.
- **Mixed-use high-rise building** — that the issue of mixed-use high-rise buildings which are not predominantly for commercial use be re-examined prior to the next review of the Act; and

- **Dividend** — That the ARPC pay an initial dividend to the Commonwealth of $400 million, to be spread over four years, with the first payment to be made in January 2013. The question of the frequency and amount of any further dividends beyond 2016 should be considered in the context of the 2015 Review.

Introduction

Overview of the scheme

Operation and coverage

The *Terrorism Insurance Act 2003* (the Act) establishes a scheme for replacement terrorism insurance coverage for commercial property and associated business interruption and public liability claims. It deems terrorism risk cover into eligible insurance contracts and establishes the ARPC, the statutory authority responsible for administering the scheme and for providing reinsurance cover for eligible terrorism losses. Insurance companies are able but not required to reinsure the risk of claims for eligible terrorism losses through the ARPC, in which case premiums are payable to the ARPC.

The Act operates by overriding terrorism exclusion clauses in 'eligible insurance contracts' to the extent the losses excluded are 'eligible terrorism losses' arising from a 'declared terrorist incident' (DTI).[3] It makes these clauses ineffective for all classes of insurance included in the scheme, for those risks covered by the policyholder's insurance. This requires insurers to meet eligible claims in accordance with the other terms and conditions of their policies.

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

- loss of, or damage to, eligible property that is owned by the insured;
- business interruption and consequential loss arising from loss of, or damage to, eligible property that is owned or occupied by the insured or an inability to use all or part of such property; or
- liability of the insured that arises out of the insured being the owner or occupier of eligible property.[4]

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

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

- buildings (including fixtures) or other structures or works on, in or under land;
- tangible property that is located in, or on, such property; and
- property prescribed by regulation.[5] The *Terrorism Insurance Regulations 2003* (the Regulations) prescribe tangible property in, on or under the seabed.[6]

Farms can also obtain cover if they hold insurance against business interruption.

The scheme does not cover residential property or contents of residential property, and does not cover Commonwealth or State Government property. The Regulations also exclude contracts of insurance for other matters including workers' compensation insurance, marine insurance, aviation insurance, motor vehicle insurance, life insurance, health insurance, private mortgage insurance, medical indemnity insurance and professional indemnity insurance.[7]

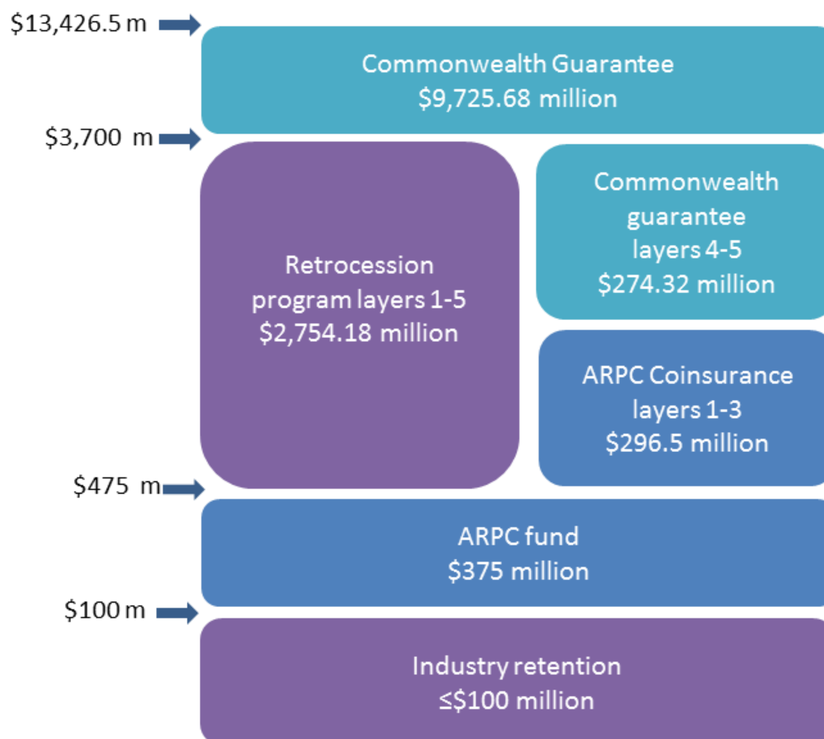
The ARPC covers eligible terrorism losses for any DTI covered by an eligible insurance contract where the insurer has a reinsurance agreement with the ARPC. Eligible terrorism losses do not include a loss or liability arising from the hazardous properties of nuclear fuel, material or waste.[8]

Funding

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

5 *Terrorism Insurance Act 2003,* section 3.
6 *Terrorism Insurance Regulations 2003,* Regulation 4.
7 *Terrorism Insurance Regulations 2003,* Regulation 5.
8 *Terrorism Insurance Act 2003,* section 3.

Figure 1: 2012 ARPC program capacity



The scheme provides $13.43 billion in capacity for insurance claims arising from a DTI. This capacity is split into several layers, with losses from a DTI covered first by the lowest layer, and subsequent layers being called on as losses increase.[9]

- The first layer of the program requires industry to retain up to $100 million in losses, which comprises the first layer of the program.
- The second layer is provided by $375 million worth of the ARPC's reserved funds.
- The third and fourth layers result in losses being split between the ARPC's retrocession program (its retrocessionaires) and the remainder of the ARPC's reserves of $296.5 million. Once the ARPC's reserves are fully exhausted, losses are split between the remainder of the retrocession program and the first $274.32 million of the Commonwealth $10 billion guarantee.

9 If the total capacity of the scheme is likely to be exhausted, the Government may announce a reduction percentage by which claims are able to be reduced.

- The fifth and final layer is fully provided by the remainder of the government guarantee.

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

Premiums charged by the ARPC fall within three tiers (A, B and C) based on population density, geographic location and defined by postcode, broadly corresponding to the underlying risk. While the reinsurance rate is not indexed, given it is calculated as a percentage of the premium paid by the policyholder to insure, it automatically takes into account changes in the underlying premium such as increases in the sum insured. Premium rates are set by ministerial direction.

As of 1 July 2009, annual insurer retentions are the lesser of $10 million and 4 per cent of an insurer's gross written premium for fire and industrial special risks (ISR) per year, with minimum insurer annual aggregate retention of $100,000. The maximum loss the insurance industry is required to fund from its own capacity is $100 million per event. If the retentions of insurers in respect of all eligible terrorism losses caused by a single DTI exceed the maximum industry retention of $100 million, the individual insurer's retention is reduced proportionately.

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

Declaring a terrorist incident and paying claims

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

Following the Minister's declaration of a terrorist incident, the scheme will provide cover, in excess of the insurer or industry retentions, to insurers within

the terms of a reinsurance agreement that the insurer has purchased from the ARPC.

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

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

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

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

Overview of the report

International approaches

Chapter 1 of this report considers the Australian terrorism insurance scheme in the context of schemes that have been developed internationally.

Including Australia, approximately 20 countries have established various kinds of cooperative terrorism insurance arrangements and of these, 10 are public-private partnerships with government involvement of varying degrees.

Government and private sector responses to managing terrorism risk are varied and no two schemes are the same. Australia’s terrorism insurance scheme has a number of similarities with schemes established in major OECD economies, but remains responsive to the particular needs of the Australian financial market. It also exists within a global reinsurance market that continues to be characterised by insufficient capacity at affordable prices for individual

risks. The proposed continuation of the scheme is consistent with the approaches of major OECD economies, where governments have yet to decide that domestic and international insurance and reinsurance markets have recovered sufficiently for the schemes to be phased out or ceased.

Need for the Act to continue

Chapter 2 considers the need for the Act to continue in the context of developments in the domestic and international insurance and reinsurance markets over the 2009 to 2012 period.

Refinements to the scheme

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

- premiums — whether the premiums charged by the ARPC adequately reflect the risk it bears from its terrorism reinsurance program and impedes in any way the commercial market from offering terrorism risk cover in Australia;
- retentions — whether current retention levels are appropriate and sufficient to encourage greater involvement of the commercial insurance market in providing terrorism risk cover;
- retrocession — whether the purchase of retrocession by the ARPC is an appropriate use of its funds; and
- mixed-use high-rise building cover — whether the scheme should be extended to include mixed-use high-rise buildings.

Payment of a dividend

Chapter 4 considers the value of the Commonwealth guarantee provided to the ARPC and the pros and cons of whether the payment of a dividend by the ARPC to the Commonwealth is appropriate at this point in time.

Appendices

The report concludes with a series of appendices covering:

- recommendations arising from the 2009 Review (Appendix A);

- the Terms of Reference for the 2012 Review (Appendix B);
- the Consultation Paper for the 2012 Review of the *Terrorism Insurance Act 2003* (Appendix C); and
- the list of stakeholders consulted for the purposes of the 2012 Review (Appendix D).

CHAPTER 1: INTERNATIONAL APPROACHES

Issue

This chapter will examine the range of terrorism insurance arrangements currently in place around the world.

Background

Overview of international approaches

Internationally, a number of countries have terrorism insurance arrangements in place. These range from private sector schemes through to wholly public sector arrangements, with a large proportion being public-private partnerships featuring a varying degree of government involvement. All schemes reflect the particular needs of individual countries and no two schemes are the same.

Around 20 countries have established terrorism insurance schemes, 11 of which are members of the OECD. A small number of schemes have been in existence for some time but most were established following the events of September 2001.

Long-established schemes include those in Spain (established 1941), Israel (1961, 1970)[10], South Africa (1979), Namibia (1987) and the United Kingdom (1993). Their existence reflects the political history of their respective countries.

For example: the Spanish scheme was established following the Spanish Civil War; the South African scheme following the political unrest of the 1970s; the Namibian scheme following a period of political unrest which preceded Namibia's full independence from South Africa in 1990; and the United Kingdom scheme in response to the political unrest in Northern Ireland.

A number of countries established schemes in the aftermath of the events of September 2001 including Austria, France, Germany, India, the Netherlands,

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10 Israel developed two programs: one in 1961 to cover property damage and another in 1970 which provides cover for bodily injuries and compensation to family members of deceased victims of terrorist attacks.

Switzerland and the United States. Some existing schemes were also broadened, including those in Spain and the United Kingdom. A small number of countries established schemes in the years following those events, including Taiwan (2004) and Belgium (2007).

Assessment

How the Australian scheme compares with other schemes

The key features of the Australian scheme are that:

- it is a temporary measure;
- it is a public private partnership;
- terrorism exclusion clauses are overridden in eligible insurance contracts;
- insurer participation via reinsurance with the government reinsurer is voluntary;
- funding for the scheme consists of a pool of funds accumulated from insurer premiums and investment revenue, reinsurance and a government indemnity;
- insurer retentions and premiums are set by government; and
- it only covers commercial property and associated business interruption and public liability risks.

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

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

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

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

Participation in the Danish scheme is voluntary for insurers that do not write NBCR terrorism insurance but mandatory for those that do.

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

These schemes typically feature a pool established by the insurance industry, in cooperation with the government. Insurers contribute premiums to the pool which purchases reinsurance and funds claims in the event of a terrorist attack. The Danish scheme replaces the pool with a government administered fund. Insurers participating in the scheme pay a fee in return for the government guarantee.

Governments of these countries act as insurers of last resort, guaranteeing to provide additional, capped, funding for the payment of claims. The guarantee serves to mutualise the risk and moderate the risks retained by individual insurance firms.

The United States' scheme does not create a pre-funded pool. The scheme requires the insurers to generate their own mechanisms for risk sharing. This has the potential for positive outcomes, where it may facilitate private markets to develop efficient mechanisms for risk sharing. However, the scheme also has the potential for negative consequences if private markets cannot develop risk sharing structures for terrorism risk. The United States has extended the operation of its scheme to at least 2014.

Further similarities can be seen where the Belgian, Danish, Dutch, French, German, United Kingdom and United States governments set insurer

retentions and/or premiums. These measures support a policy intention to encourage a greater level of private sector coverage, reduce government involvement, and avoid government 'crowding out' incentives for private sector competition.

While the Australian scheme covers commercial property and mixed-use property that has predominantly commercial flood space, a number of schemes amongst other OECD countries go further, covering residential property and their contents. Some schemes also cover other asset classes including motor vehicles, trains and ships. The German, United Kingdom and United States schemes are most similar to the Australian scheme, focussing on cover for commercial property and business interruption.

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

The 2009 Review contains a substantive analysis of the above schemes.

International Developments since the 2009 Review

Denmark introduced a public-private partnership scheme in 2010; and an insurance consortium made up of a number of Singapore-based Lloyd's syndicates was launched in 2012 to provide terrorist insurance protection to businesses operating in South East Asia and the Asia Pacific region (see below for further details).

Denmark

Denmark enacted the *Terrorism Insurance Act* in 2010. This Act establishes a public-private partnership scheme to provide coverage for losses arising from damage to real estate, trains, cars and ships caused specifically by nuclear, chemical, biological and radiological (NBCR) terrorism.

Participation is voluntary for both Danish and foreign non-life insurance companies which do not write NBCR terrorism insurance, but compulsory for those insurers that write NBCR terrorism insurance. Provision of terrorism insurance is not compulsory in Denmark.

The scheme created a Terrorism Insurance Council which recommends annual insurance industry retention levels. These are based on the availability of NBCR reinsurance on the international market and the solvency position of the insurers. As of 2010, the risk to be retained by NBCR insurers was set at DKK 5 billion. In addition, the government provides a guarantee to cover losses from NBCR events that exceed this retention amount. This guarantee is capped at DKK 15 billion per year.

The procedure by which this retention amount is determined indicates that should the availability of NBCR reinsurance in the private sector improve, this would automatically be reflected in an increase in the retention amount, and ultimately retention could actually exceed the worst case scenario, making the state guarantee superfluous.

Participants pay a risk premium fee to the government in return for the provision of the guarantee. The scheme must not result in a call on the Danish government budget over time. Therefore, were an NBCR terrorist attack to occur with losses of a magnitude that triggers a call on the Government guarantee, the Government will levy a tax on policyholders so as to recover any shortfall between the amount paid by the Government and the total amount previously paid to it in risk premium fees.

Singapore

The Xin Consortium, a Singapore-based consortium made up of four Lloyd's syndicates, was launched in early 2012 to provide insurance cover for terrorism, strikes, riots and civil commotion for businesses operating in South

East Asia and the Asia Pacific region.[11]

The consortium offers cover to both large and small businesses operating in a range of industries, from maritime ports through to banks, hotels and offices, telecoms and stadia, light and heavy manufacturing, airports, logistics and others. Protection up to a maximum of US$110 million for a single risk is offered.

Conclusion

In conclusion, as with a number of other schemes around the world, Australia's scheme was a response to a general withdrawal of terrorism insurance from the private insurance market in the aftermath of the events of September 2001. As with most other schemes, it was implemented as a temporary measure pending renewed availability of terrorism insurance and the continuing need for it is subject to regular review.

It shares features with a number of other schemes implemented by OECD countries and is perhaps most similar to the schemes found in Germany, the United Kingdom and the United States.

Although it covers a narrower range of assets and risks than some other schemes, it has been structured to meet the particular needs of Australia's financial market.

11 Lloyd's, *New terrorism consortium to protect under-insured*, 26 March 2012, viewed on 27 March 2012, http://www.lloyds.com/News-and-Insight/News-and-Features/Market-news/Industry-News-2012/New-terrorism-consortium-to-protect-underinsured.

Chapter 2: Need for the Terrorism Insurance Act

Issue

This chapter will examine whether there is a need for the *Terrorism Insurance Act 2003* to continue in operation.

Background

Australia's terrorism insurance scheme was established to minimise the wider economic impacts that flowed from the withdrawal of terrorism insurance post 11 September 2001.

The lack of affordable terrorism insurance forced Australia's commercial property owners, banks, superannuation funds and fund managers to assume their own terrorism risk, as existing policies expired and renewal policies explicitly excluded terrorism cover. The Australian government was concerned that the lack of terrorism insurance for commercial property and infrastructure would lead to a reduction in financing and investment in the Australian property sector, with subsequent wider negative economic impacts.

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

To protect the economy from the effects of the withdrawal of terrorism insurance, the Government announced in May 2002 that it would offer insurance for losses above the cover available from individual insurers, possibly under a pooling arrangement. Furthermore, it was announced that any intervention would need to be consistent with:

- the need to maintain, to the greatest extent possible, private sector involvement;

- ensuring that risk transferred to the Commonwealth is appropriately priced;
- allowing the re-emergence of the commercial markets for terrorism risk cover; and
- global solutions.

Subsequently, the Government established the scheme on 1 July 2003 for commercial property and associated business interruption losses and public liability claims. The scheme is an interim measure, intended to operate only while terrorism insurance cover is unavailable commercially on reasonable terms.

At the time the scheme was established, the Government also considered that uncertainty in the market made it impossible to stipulate the details or timing of its windup.[12] As a result, section 41 of the Act requires that at least once every three years of the scheme's operation, the Minister must prepare a report that reviews the need for the Act to continue. This requirement of section 41 of the Act is set out in the Terms of Reference for this Review (see Appendix B).

2006 Review Findings

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

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

The 11 September 2001 attacks resulted in an increase in the risk associated with high-rise commercial property. Consequently, insurers excluded terrorism cover in all-risks policies and faced increased demand for standalone terrorism cover. Premiums rose sharply and contracts were more restrictive as insurers selected their risks more carefully and required policy holders to meet stringent security requirements. The overall effect was a shortage of affordable terrorism insurance.

The 2006 Review found that the development of government schemes[13] to address the shortfall in commercially available reinsurance at affordable rates

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12 *Terrorism Insurance Bill 2003, Revised Explanatory Memorandum*, para 1.8.

13 See Chapter 1, International Approaches, for further information about a range of terrorism insurance arrangements around the world.

was probably the most significant contributing factor to the stabilisation of the international terrorism insurance market between 2003 and 2006. During that time, the market was characterised by improvements in the availability and affordability of terrorism insurance: insurance and reinsurance capacity increased; the financial stability of insurers improved; insurer retentions increased; premiums fell or stabilised at competitive rates; and participation rates increased.

However, at the time of the 2006 Review, standalone cover remained expensive, restrictive and limited in its availability. Financial markets showed little appetite for terrorism risks and there was no expectation that market capacity would increase substantially in the short term.[14]

Consequently, the 2006 Review of the Act concluded that there was still a need for the Act to continue in operation, subject to a further review within three years. The Review noted that while the market for terrorism insurance had recovered somewhat since the scheme was introduced, there remained insufficient terrorism insurance on commercially reasonable terms.

2009 Review Findings

There was further improvement in the global market for terrorism insurance in the two years following the 2006 Review, although the terrorism insurance market hardened during 2008 and into 2009 as insurers and reinsurers responded to a decline in the value of investment portfolios due to the impact of the global financial crisis (GFC).

Despite the incremental improvement in the market, insurers consistently expressed the view that there was insufficient commercial capacity to meet demand for terrorism insurance in Australia at affordable rates, particularly in high-risk locations, and that loss events beyond a certain scale surpassed the risk capacity of the industry. Insurers considered that government schemes remained as relevant and necessary at this time as they were at the time of their establishment.

In light of the underlying shortage of affordable reinsurance for terrorism risk and the impact of the GFC on the availability and affordability of reinsurance, the 2009 Review concluded that there was a need for government involvement and for the Act to continue in operation for another three years to protect the broader Australian economy from the adverse effects of the withdrawal of terrorism insurance.

14 The Treasury, *Terrorism Insurance Act Review: 2006*.

2012 Review Findings

The general insurance market in Australia

The period leading up to the GFC was marked by an intense price war amongst insurers, with strengthening investment conditions supporting the industry's surplus capital position. However, high catastrophic losses combined with the onset of the global financial crisis resulted in successive years of poor profitability and an erosion of the industry's reserves, limiting insurers' abilities to supply coverage and placing upward pressure on prices.[15]

The industry continues to face tough challenges, including an uncertain global economic environment, difficult underwriting conditions and increased reinsurance costs as a result of a spate of natural catastrophes across the Asia Pacific region over the last two years — floods in Australia and Thailand, a tsunami in Japan, cyclones, bushfires and hailstorms in Australia, and earthquakes in New Zealand.

Although faced with an unprecedented number of claims related to these natural disasters, Australia's general insurance industry achieved a return on net assets of 13 per cent over 2010-11 (to 30 June), slightly lower than the 16 per cent recorded in the previous financial year, while gross written premium increased by three per cent over the same period.[16] Net profit after tax for the industry in 2010-11 was over $3.9 billion, a more than $750 million drop from 2009-10, but around 50 per cent larger than the profit figure for 2008-09.[17]

In its *Financial Stability Review* of March 2012, the Reserve Bank of Australia noted that despite the claims impact of the recent natural catastrophes in Australia and across the region, the Australian insurance industry remains well capitalised, holding capital as at June 2011 equivalent to about 1.8 times APRA's minimum capital requirement.[18] This was down from 1.9 times as at December 2010. Insurers' strong capital levels are reflected in their relatively strong credit ratings: the Australian operations of the largest insurers are rated A+ or higher by ratings agency Standard and Poor's.

An important factor limiting the financial impact of the recent natural disasters was the insurers' reinsurance arrangements, as a significant number of the claims relating to the Australian disasters were covered by reinsurance with private-sector reinsurers, and in the case of the New Zealand earthquakes by the New Zealand government-owned Earthquake Commission.[19] Not

15 IbisWorld Industry Report K7422: *General Insurance in Australia 2012.*
16 APRA Insight, Issue 2, 2011, *General Insurance Industry Overview.*
17 Ibid.
18 Reserve Bank of Australia, *Financial Stability Review — March 2012.*
19 Reserve Bank of Australia, *Financial Stability Review — September 2011.*

surprisingly, reinsurance costs are increasing as reinsurers seek to recoup recent losses and reprice risk. As a consequence, premiums across a range of insurance lines are rising, as primary insurers pass on some of the increase in their reinsurance costs. Estimates of the increases in reinsurance premiums vary widely, but most are in the range of 20 to 60 per cent, which is expected to translate to an average premium increase for consumers of about 5 to 10 per cent.[20]

The 2011-12 year continues to be a challenging one for the insurance industry in Australia. Hailstorms in Melbourne on Christmas day and extensive flooding across parts of eastern Australia during the 2012 summer has brought another large number of claims, although the estimated value of the claims from these events is nearly $800 million, well below the estimated $4 billion for the flooding events of 2010-11 and Cyclone Yasi.[21]

The reinsurance market in Australia

The impact on the reinsurance market in Australia and New Zealand from the recent catastrophes has been marked. A number of the reinsurers suffered large losses, estimated at approximately $25 billion in total. Accordingly, Australian property reinsurance is in some cases being significantly repriced, with pressure being applied to retention levels and risk adjusted pricing increases generally in the range of 15 per cent to 70 per cent.[22] Notwithstanding the above pressures, ample reinsurance capacity remains available for Australian property programs, although some second tier reinsurers have completely withdrawn their capacity from the Australasian market following the recent loss activity.[23] The repricing in the property reinsurance market is not flowing through to the casualty risk class, which continues to benefit from an increased supply of reinsurance capacity as reinsurers attempt to diversify away from loss-affected property classes.[24]

While there is no correlation between weather losses and terrorism, they are often handled by the same reinsurance property underwriters. Both the property catastrophe and terrorism markets are characterized by low-frequency, high-severity exposures, claims for which are paid for from the same pool of available capital. As such, the recent natural catastrophe losses and industry capital decrease has necessitated reinsurers evaluate all

20 Ibid.
21 Reserve Bank of Australia, *Financial Stability Review — March 2012.*
22 Aon Benfield, *Reinsurance Market Outlook: Value Creating Capital*, September 2011.
23 Willis Re, *1st View,* 1 July 2011.
24 Ibid.

catastrophic exposure allocations and strategies, including for the peril of terrorism.[25]

ARPC entered the retrocession market to place its 2012 reinsurance program as the Thai floods were unfolding and at a time of contraction in market capacity and some upward pressure on prices. Overall, the ARPC was able to renew its retrocession program with slight cost savings and an increased purchase of cover, but this was achieved by taking a co-reinsurance line throughout the program and by buying cover higher up in the program where rates are lower.

Assessment

Stakeholder views

In their consideration of whether there is a need for the Act to continue, and in essence for the ARPC to continue to operate a terrorism pool, stakeholders were uniformly of the view that while global capacity for reinsurance of terrorism risk is returning, the Australian market is characterised by insufficient capacity at affordable rates. Many stakeholders consider that the current commercial market capacity in Australia could not replace the scheme's current size of $13.4 billion. While some stakeholders noted that it is difficult to determine the capacity of the commercial market for terrorism insurance absent the ARPC, estimates put forward by some reinsurers ranged between $3 billion and $4 billion.

- The ARPC pool enables global reinsurance to centrally support the Australian market with specific reinsurance protection. The establishment of a central authority allows for consistency in coverage, price, accumulation control and loss scenario modelling that would otherwise be fragmented. It also facilitates a higher aggregate retention which in turn generates a higher reinsurance capacity. This allows reinsurers to price their risk accordingly. Without the capacity of the ARPC to funnel the risks into a central pool, it is unlikely that sufficient reinsurance capacity would be made available by reinsurers, and the situation would revert back to the 'market failure' position post 11 September 2001. Furthermore, reinsurers feel they are not being selected against if they are in a position to reinsure national portfolios of risk rather than particular exposures within a portfolio.

- The scheme is well run and understood and provides certainty for the market in terms of the reinsurance response in the event of a terrorist

25 Guy Carpenter, *Terrorism: Terror market continues to provide abundant cover*, September 2011.

incident. There would be concerns about the ability of the commercial market to respond in a timely manner to a significant terrorism incident.

- Terrorism risk carries with it very high accumulation potential and is also subject to sudden swings in exposure patterns as geopolitical moods change across the globe. These are the principal reasons why the risk is classified as an undesirable exposure. Accordingly, many reinsurers have taken a decision to only provide capacity for central pools for terrorism risk around the world, including in Australia through the ARPC.

- The insurance and reinsurance market in Australia is currently undergoing some significant re-pricing, and any significant changes to the scheme, including any wind-up of the scheme, would not be welcome at this point in time. Making any drastic changes to the scheme would be an added burden to the property sector.

It should be noted that not one stakeholder considered that the Act should be abolished and the scheme wound up in some way. Conversely, stakeholders were uniformly of the view that the Act and the scheme should continue to operate.

Need for the Act to continue

Although the Australian general insurance industry is relatively well positioned, it is nonetheless part of the international reinsurance market, which has recently faced tough conditions. Significant losses from the tsunami in Japan, earthquakes in New Zealand and Chile, cyclones in North America, and floods in Australia, resulted in tens of billions in losses to the industry. Willis Re estimated that in the 16 months to July 2011, natural catastrophe losses cost the reinsurance industry around $50 billion.[26]

Given the recent losses suffered by reinsurers, reports of a repricing of risk in the reinsurance market in Australia are not unexpected. Significant pressure is being applied to retention levels, pricing on loss-affected layers and minimum rates on line charged on upper layers. This, combined with the withdrawal by some secondary reinsurers from the Australian market, has led to somewhat of a contraction in the reinsurance market in Australia, although capacity remains. Some reinsurers noted during the consultation for the 2012 Review that Australia was now considered a riskier place to do business and accordingly, reinsurance prices were rising and the terms and conditions of that reinsurance cover were tightening to reflect that new perception.

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26 Willis Re, *1st View,* 1 July 2011.

These developments have occurred against an underlying shortage of reinsurance capacity for individual terrorism risks at affordable prices, a situation that has remained unchanged since 2009.

In light of the underlying shortage of affordable reinsurance for terrorism risk and the impact of large scale reinsurance losses across the Asia Pacific area on the availability of reinsurance, this Review concludes that there is a need for government involvement and for the Act to continue in operation for another three years to protect the broader Australian economy from the adverse effects of the withdrawal of terrorism insurance.

However, the scheme was established to operate only while terrorism insurance cover is unavailable commercially on reasonable terms, and maintain, to the greatest extent possible, private sector provision of terrorism insurance to the Australian market. Consideration of the need for the Act to continue in operation should be reviewed within three years, as specified in the Act.

Recommendation

That the Act continue in operation, subject to a further review within three years, at which time an examination of the availability of commercial terrorism reinsurance on reasonable terms be undertaken.

CHAPTER 3: REFINEMENTS TO THE SCHEME

This chapter considers refinements to the following aspects of the scheme:

- pricing of insurance premiums;
- industry retentions;
- retrocession (reinsurance purchased by ARPC); and
- eligibility of mixed-use high-rise buildings in the scheme.

3.1 Pricing of insurance premiums

Issue

Whether the ARPC's pricing:

- adequately reflects the risks it bears from its terrorism reinsurance program; and
- is in any way impeding the private market from providing terrorism insurance in Australia.

Background

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

Premiums paid to the ARPC replicate commercial reinsurance arrangements by insurers. The premiums charged for reinsurance are determined by Ministerial Direction and are calculated as a percentage of the underlying premium. Reinsurance premiums therefore automatically reflect changes in underlying premiums such as increasing sums insured, which are a matter for each insurer to determine.

The premiums are set based on the level of risk. There are three broad tiers based on population density and geographic location which are identified by postcode. Table 1 below demonstrates the breakdown of tiers and the geographical location to which they relate.

Table 1: Tier based on geographical location

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

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

Reinsurance premiums are calculated as a percentage of the premium written by the reinsured that is attributable to the eligible insurance contract, in accordance with the following table.

Table 2: Premium structure for reinsurance

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

When the scheme was first established, it was considered that reinsurance premiums of between 2 and 12 per cent of underlying commercial property insurance premiums would be adequate to build the pool (reserves for claims) and would not be a significant cost to smaller commercial property owners if passed on by insurers. As potential public liability costs are difficult to quantify, and in the absence of a significant claim on the scheme, no initial premium payable for reinsurance of terrorism risk in this class of insurance has been required. However, in the event of a significant claim on the scheme,

reinsurance premiums would be required to be paid for reinsurance of public liability claims.

The premium levels were reviewed in 2006 and 2009. Reflecting the recommendations made in these Reviews, the premium levels have remained unchanged since 1 October 2003.

Assessment

In principal, pricing undertaken by a Commonwealth agency such as the ARPC should meet three objectives;

1. the Government should be fairly compensated for providing protection of a commercial nature against terrorism events;
2. the interest of taxpayers should be protected, given the Commonwealth provides a $10 billion guarantee; and
3. pricing should not discourage greater private sector involvement of the commercial insurance market in providing cover for terrorism.

Analysis of the scheme against these three objectives supports the case for the ARPC to continue to collect premiums at current levels. Industry participants in their submissions also agreed.

The lack of a deep commercial market in terrorism risk makes it difficult to assess whether the ARPC's pricing adequately reflecting the risks it bears from its terrorism reinsurance program. However, the following observations can be made.

- The risk of a terrorism event in Australia has not lessened or increased. Australia has been at a medium level of alert since the four levels of national counter-terrorism alert were introduced in 2003.

- The design feature of the current pricing policy allows for premiums to rise as property values rise. This is because the reinsurance premium payable to the ARPC is set as a percentage of the underlying insurance premium paid to cover risks other than terrorism.

- Industry participants see no reason to reduce or increase the ARPC's current pricing. For example, the Insurance Council of Australia considers that ARPC's pricing of terrorism suitably reflects the risk.

Based on stakeholder feedback, and in the absence of data and benchmarks for pricing, the Review considers that the ARPC's pricing is adequate. This is justifiable on the basis of the scheme continuing to grow its capacity through its reserved funds and retrocession program. Furthermore, there is no evidence of

the scheme's pricing preventing the private sector from re-entering the market, although some stakeholders noted that an increase in prices charged by the ARPC could encourage greater (albeit limited) additional commercial market capacity. These observations support the view that the ARPC's pricing adequately reflects the risks it bears from its terrorism reinsurance program. Further, the stability of the scheme since its introduction in 2003 provides a strong reason to retain the current pricing arrangements.

The recommendation in Chapter 2 that the terrorism insurance scheme should continue to operate reflects the lack of a commercial market for terrorism risk cover. Industry participants are of the view that the presence of the terrorism insurance scheme and the ARPC's current pricing policy is not inhibiting the re-emergence of a commercial market for terrorism risk. In particular, the scheme does not prevent competitors from entering the market.

The Review therefore finds that the ARPC's pricing policy:

- adequately reflects the risks it bears from its terrorism reinsurance program and should be retained; and
- is not impeding the re-emergence of the commercial market in the provision of terrorism risk cover in Australia.

Recommendation

That the ARPC's current pricing policy remain unchanged.

3.2 Industry retentions

Issue

With respect to industry retentions, the issues to be considered are whether:

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

Background

One of the underlying principles of the scheme is that it should be designed to allow the re-emergence of the commercial market for terrorism risk cover. Raising retention levels requires insurers to retain a greater amount of terrorism risk, which they can decide to self-insure or seek to commercially reinsure. Either course of action increases private sector involvement in the provision of terrorism risk cover. Increasing retentions also increases the relative attractiveness of commercial terrorism cover, and may marginally reduce the cost of retrocession coverage for the scheme since insurers would be retaining a larger amount of risk at a lower layer of the scheme.

The 2006 Review recommended that retention levels under the scheme be increased in order to make them more comparable with commercial reinsurance and similar schemes overseas and to require commercial insurers to assume more terrorism risk. As a result, the *Treasurer to Australian Reinsurance Pool Corporation (Risk Retention) Direction 2007* required retentions to be increased in three increments, as set out below. The last of the retention increases came into effect on 1 July 2009. The current and past retention levels of the scheme are presented in Table 3.

Table 3: Annual insurer and industry retentions

Date	Annual insurer retention		Maximum industry retention per incident
	Minimum	Maximum	
Occurring before 30 June 2007	Nil	The lesser of $1 million or 4 per cent of fire and ISR premiums collected	$10 million
1 July 2007 to 30 June 2008	$100,000	The lesser of $1 million or 4 per cent of fire and ISR premiums collected	$25 million
1 July 2008 to 30 June 2009	$100,000	The lesser of $5 million or 4 per cent of fire and ISR premiums collected	$50 million
Occurring after 30 June 2009	$100,000	The lesser of $10 million or 4 per cent of fire and ISR premiums collected	$100 million

The retention figures set out in Table 3 represent the annual aggregate retention to be applied to each individual entity which reinsures with the ARPC, regardless of whether the entity is a subsidiary of a larger company which also

reinsures with the ARPC. The Explanatory Memorandum to the Terrorism Insurance Bill reinforces the view that it was the Government's intention that a separate retention be applied to each individual entity which reinsures with the ARPC.

Industry retention levels remain at the levels that took effect on 1 July 2009. The 2009 Review noted that the appropriateness of the current levels and structure of retentions should be re-examined in the course of the 2012 Review.

Assessment

For the 12 months to 31 March 2012, the ARPC reinsured the terrorism exposure of 248 insurers. Of these, 176 are subject to the minimum $100,000 retention.

The appetite for the private provision of terrorism insurance remains low, and capacity is not readily available at reasonable rates. Any further increases in retentions could exacerbate the difficulties insurers have in obtaining cover to reinsure their retentions. In addition, increasing retentions may require insurers to hold additional terrorism risk, which would in turn require them to hold additional capital as a buffer for this risk.

Industry stakeholders consulted during the Review considered that the current structure and level of retentions is appropriate due to the above reasons. For example, several stakeholders maintained that while there is some capacity in the market for insurers to reinsure their retention amounts, this market is quite limited and it is not known whether the market could provide sufficient capacity should the retention levels be raised. Another argued that it would be inappropriate to raise retention levels given the current reinsurance environment.

Recommendation

That ARPC's current industry and individual insurer retention levels remain unchanged.

3.3 Retrocession

Issue

The issue to be examined in this section is whether the continued purchase of retrocession by the ARPC represents an appropriate use of the funds.

Background

The 2006 Review suggested that once the pool reached $300 million, the ARPC could use premium income to build the pool further, purchase retrocession for the scheme or undertake a combination of both. The 2009 Review found that the purchase of retrocession would have a number of benefits which would increase the effectiveness of the pool through:

- giving the scheme additional capacity in the event of a terrorist incident which reduces the Commonwealth's exposure to losses in excess of the pool and hence lessens the likelihood of a reduction percentage being required; and
- improving the financial stability and liquidity of the scheme; and
- enhancing its credibility, thereby encouraging commercial involvement in the scheme and the terrorism insurance market more generally.

Reflecting the outcome of these Reviews and the pool exceeding $300 million, the ARPC has purchased retrocession every year since 2009. It initially provided cover of $2.3 billion, and was subsequently renewed and increased in 2010 to $2.6 billion and again in 2011 to $2.75 billion.

The ARPC renewed its retrocession program on 1 January for 2012. There are several changes to the structure of the program, most notably the use of ARPC's reserves in co-reinsuring the program. This has resulted in the amount of retrocession purchased increasing by $11 million, bringing the total capacity of the scheme to over $13.4 billion. This increase in capacity was achieved while reducing its retrocession premium costs from $81 million for the 2011 program to $71.7 million for 2012.

Assessment

Observations which can be made in support of continuing the current arrangements include that the retrocession program:

- encourages the return of the commercial terrorism insurance and reinsurance market for Australian risks;
- increases the overall capacity of the scheme;
- places the Commonwealth further from the risk of terrorism losses under the scheme; and
- reduces the likelihood that a reduction percentage will be required.

Consultations as part of the Review found that industry participants were uniformly of the view that the retrocession program represents a prudent use of the ARPC's funds. One stakeholder argued that, in addition to the retrocession program being a cost-effective method of divesting liability, it also provided a highly useful indicator of changes in the terrorism insurance market.

The growth of the scheme has continued unabated since it was first established, owing in large part to a history of no claims against the scheme and the growth of ARPC's retrocession program. To date, there has been no evaluation on what would constitute an appropriate size of the scheme. The level of retrocession purchased by the ARPC and the size of the Commonwealth guarantee, which has not changed since the commencement of the scheme, should also be evaluated as part of an assessment of the appropriate size of the scheme. This assessment should be undertaken as part of the 2015 Review.

Recommendation

- That an assessment of the appropriate capacity of the scheme should be undertaken as part of the next review of the Act, taking into consideration the size of the government guarantee and any retrocession purchased by the ARPC, as well as the level of the ARPC's exposure to risk; and

- That the next review of the Act should reassess the continuing need for, and cost benefit of, the ARPC's retrocession program in the context of the review of the capacity of the scheme.

3.4 Mixed-use high-rise building cover

Issue

While not specifically mentioned in the Review's terms of reference, many of the stakeholders contacted by the Review raised the issue over whether the scheme should be extended to cover mixed-use high-rise buildings.

Background

The scheme was never intended to provide cover to the residential property sector. The 2006 and 2009 Reviews of the need for the Act to continue recommended the continued exclusion of residential property from the scheme.

The 2006 Review did not support the extension of the scheme to include predominantly or wholly residential high-rise buildings. It concluded that there

was no evidence to suggest that either the willingness of lenders to provide finance for residential developments, or sales of residential apartments in high-rise buildings, had reduced due to the withdrawal of terrorism insurance. The Review also concluded that the increased transfer of cost and risk from property owners to the Australian government would substantially increase the costs of the scheme while producing limited benefit.

The 2009 Review reaffirmed the findings of the 2006 Review with respect to the exclusion of wholly or predominantly residential high-rise developments, but noted that mixed-use high-rise developments were becoming more prevalent in central business districts and were perceived as a higher risk than wholly commercial use buildings located outside central business districts. It therefore recommended that ARPC examine the effects of extending the scheme to mixed-use high-rise buildings that are not predominantly for commercial use, having regard to the need to maintain, to the greatest extent possible, private sector provision of terrorism insurance, and allow the re-emergence of commercial markets for terrorism risk cover.

A Finity Consulting study commissioned by the ARPC[27] examined the issue of mixed-use high-rise buildings and found that:

- mixed-use high-rise residential buildings valued under $50 million with up to 20 per cent of floor area devoted to commercial use were able to obtain terrorism cover from the direct market;
- mixed-use high-rise buildings valued under $50 million with between 20-50 per cent of floor area devoted to commercial use were unable to obtain terrorism cover in the private reinsurance market and are ineligible for cover under the *Terrorism Insurance Act 2003*; and
- mixed-use high-rise residential buildings valued over $50 million with less than 50 per cent of flood area devoted to commercial use were unable to obtain terrorism cover in the private reinsurance market and are ineligible for cover under the *Terrorism Insurance Act 2003*.

Finity Consulting found that facultative cover is available for mixed-use high-rise buildings, albeit at a very high price and with limited capacity.

It examined further the effects of extending cover to those properties identified above who are unable to obtain cover through the private market or ARPC, and found that as only a relatively small number of large mixed-use buildings existed in Tier A locations, extending cover to these properties would not

27 Australian Reinsurance Pool Corporation, *'Terrorism Insurance Act 2003: Examination of the effects of extending the terrorism insurance scheme established by the Act to mixed-use high-rise buildings which are not predominantly for commercial use'*. http://www.arpc.gov.au/?/about/theact/mixeduse.

materially change the Australian government's exposure, increase the ARPC's maximum loss scenario or increase the cost of the retrocession program. The impact on policyholder premiums for mixed-use buildings in Tier A locations was found to be approximately a 15 per cent increase of their fire or industrial special risks policies.

In its consideration of the issue of large mixed-use buildings, the ARPC Board did not recommend inclusion of such buildings in the scheme, on the basis that doing so might restrict the introduction of an industry solution to the unavailability of terrorism insurance, an outcome contrary to the Government's objective of operating the scheme only while terrorism insurance cover is unavailable commercially on reasonable terms.

Discussion

While the ARPC rejected inclusion of large mixed-use buildings in the scheme in 2010, many stakeholders have contended to the Review that they be included, or that the issue should at least be reconsidered. While the Review was unable to give the issue proper examination due to time constraints, it considers that it should be re-examined. Any re-examination should have regard to the need to maintain, to the greatest extent possible, private sector provision of terrorism insurance, and allow the re-emergence of commercial markets for terrorism risk cover.

Recommendation

That the issue of mixed-use high-rise buildings which are not predominantly for commercial use be re-examined prior to the next review of the Act.

CHAPTER 4: PAYMENT OF A DIVIDEND

ISSUE

This chapter considers whether the ARPC should now commence paying the Commonwealth a dividend, and if so, what the amount and timing of the dividend should be.

BACKGROUND

Since its inception, the terrorism insurance scheme has been backed by a Commonwealth guarantee of the ARPC's liabilities to the amount of $10 billion. From the outset, it was anticipated that the ARPC would compensate the Commonwealth for providing the guarantee.[28] This is consistent with Government policy to be compensated for any risk it assumes, where possible, and consistent with many other jurisdictions with similar government-backed schemes, which require payment of regular dividends.

To date, no fees or dividends have been paid by the ARPC to the Commonwealth. The ARPC is also not subject to Commonwealth income tax.

The terrorism insurance scheme commenced operation on 1 July 2003 with minimal funds and used premiums to build an insurance pool. The Government did not require payment of dividends or fees during the period of the accumulation of the ARPC pool to the targeted levels. The initial target for the insurance pool of $300 million was reached in 2006-07. At the time of establishment, it was envisaged that the scheme's capacity would be $10.3 billion, namely a cash pool of around $300 million and a Commonwealth guarantee of $10 billion.

In addition to building an insurance pool, the ARPC has used premiums to purchase over $2 billion of retrocession each year since 2009. The purchase of retrocession has slowed the accumulation of ARPC funds but has given the scheme additional capacity in the event of a terrorist incident. In 2012, the ARPC has applied some of its assets in a program of 'co-reinsurance', to maximise the capacity of the scheme.

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28 *Terrorism Insurance Bill 2003, Revised Explanatory Memorandum*, para 2.2. Express provision was also made for the payment of dividends in s38 of the Terrorism Insurance Act 2003.

The ARPC's assets, including the pool of $300 million, currently amount to more than $700 million. Coupled with the retrocession program and Commonwealth guarantee, the capacity of the terrorism insurance scheme now exceeds $13 billion.

In considering whether the ARPC should now commence paying the Commonwealth a dividend, and if so, what the amount and timing of the dividend should be, the Review sought advice from the Australian government Actuary (AGA) and the ARPC. The Review also undertook targeted consultation in relation to whether there are additional factors the Government should consider if the Government were to require the ARPC to pay a dividend.

Assessment

Any decision to require payment of dividends by the ARPC to the Commonwealth should take into consideration the value of the government guarantee provided to the scheme since 2003, consistent with the original intention that the ARPC compensate the Commonwealth for providing it. The decision, including in relation to the appropriate amounts and timing for any payments, should also take into account the current capacity of the scheme and its ongoing sustainability.

The AGA has estimated the value of the Commonwealth guarantee provided from inception of the scheme to the end of 2011 to be in excess of $800 million.[29]

Modelling commissioned by the ARPC in 2010 indicates that the scheme's current capacity is sufficient to enable it to cope with claims arising from a major terrorist event in the central business district of a major Australian city, without the need to apply a reduction percentage under the Act.

As noted in Chapter 3, there has been no judgement made on what would constitute an appropriate size for the scheme to grow to and there is a recommendation that this be considered in the 2015 Review.

In the absence of this judgement, this Review considers that it would be appropriate, at this time, to structure the amounts and timing of dividend payments in a manner which enables the scheme's current capacity to be maintained.

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29 This figure is based on the premium the ARPC would have been required to pay since July 2003 if it had taken out reinsurance of an amount equal to the guarantee, on the assumption that the commercial reinsurance market would have provided this much capacity and the price it would have charged is in line with the prices actually charged for the ARPC's 2011 retrocession program.

The AGA was specifically asked to consider the impact of an initial amount of $400 million to be spread over four years in a dividend profile consistent with the goal of maintaining the capacity of the scheme at close to the current level, so as not to materially impact on the capacity of the ARPC to pay claims. The AGA noted that it is difficult to know with confidence the size of a possible claim on the scheme. However, the AGA considered that the payment of four annual dividends amounting to a total of $400 million would not materially reduce the likelihood that the scheme would be able to fully meet the cost of claims that might arise.

The AGA also noted that requiring payment of $400 million, spread over four years, would reduce the scheme's capacity by around 3 per cent, without taking into account future income such as premiums and investment income. This broadly maintains the capacity of the scheme at current levels.

The ARPC has advised that payments totalling $400 million, spread appropriately over four years, would not impact on its ability to obtain similar levels of retrocession to previous years and therefore keep the overall capacity of the scheme at around $13 billion. The ARPC has also advised that such a set of dividend payments would not impact on the scheme or its operations.

In consultations the question was put to stakeholders that if the government required the ARPC to pay a dividend are there factors, beyond considerations such as the current capacity of the scheme and its ongoing sustainability, that the government should consider. The majority of stakeholders did not identify any issues. Some, however, objected to the payment of a dividend on the basis that any dividend payment would reduce the size of the scheme. As previously noted, the 2015 Review will specifically consider the appropriate size of the scheme.

With respect to timing of an annual dividend payment, the Review notes that the ARPC purchases retrocession on 1 January for the coming year. Requiring the first annual dividend payment to be made in January 2013 would allow the ARPC to factor this payment into its decisions concerning its 2013 retrocession program. The question of the frequency and amount of any further dividends beyond 2016 should be considered in the context of the 2015 Review.

Recommendation

That the ARPC pay an initial dividend to the Commonwealth of $400 million, to be spread over four years, with the first payment to be made in January 2013. The question of the frequency and amount of any further dividends beyond 2016 should be considered in the context of the 2015 Review.

APPENDIX A

SUMMARY OF RECOMMENDATIONS — 2009 REVIEW

The 2009 Review investigated the provision of terrorism insurance and the operation of the ARPC in detail. Not only did it consider the need for the continuing operation of the pool but it considered a number of areas where the scheme could be refined.

The 2009 Review, like the current Review, came at a time when the private market had little appetite for insuring terrorism losses. Although there had been some limited signs of improvement in the availability and affordability of terrorism insurance prior to 2008, by 2009 the market provision of terrorism cover had deteriorated in response to the global financial crisis.

The Review found that there was insufficient market capacity to meet the demand for terrorism insurance at affordable rates. The Review recommended that the ARPC continue to collect premiums at the same rates, that industry retention levels remain unchanged and that the ARPC continue to purchase retrocession. Due to the increased liquidity of the pool, the 2009 Review recommended that the line of credit facility was no longer required. These recommendations were accepted by the Government and implemented.

The 2009 Review recommended that the 2012 Review consider the relationship between premiums and the pool and the impact of retrocession on the pool and the scheme more generally. These issues are addressed in Chapter 3.

The 2009 Review also recommended that the ARPC examine the effects of extending the scheme to mixed-use high-rise buildings that are not predominantly for commercial use. The ARPC responded to the recommendation by producing the report '*Terrorism Insurance Act 2003: Examination of the effects of extending the terrorism insurance scheme established by the Act to mixed-use high-rise buildings which are not predominantly for commercial use*'. The Report found that mixed-use high-rise buildings valued at more than $50 million or with between 20 and 50 per cent of floor space devoted to commercial use could not obtain automatic terrorism cover and the terrorism cover available was limited and expensive. The ARPC did not recommend inclusion of large mixed-use buildings in the scheme, arguing that doing so might restrict the introduction of an industry solution to the unavailability of terrorism insurance, an outcome contrary to the Government's objective of operating the scheme only while terrorism insurance

cover is unavailable commercially on reasonable terms. The Government accepted the ARPC's recommendation.

The 2009 Review recommended that property that is wholly for residential use, including defence force and student accommodation involving commercial property financing, be excluded from the scheme. The Government accepted the recommendation.

The 2009 Review suggested that Treasury, with the assistance of an outside contractor, update the allocation of individual postcodes to particular tiers to ensure that all postcodes are allocated to the correct tier. An analysis undertaken by Treasury and Geoscience Australia recommended some minor changes to the allocation of postcodes to particular pricing tiers. These changes were implemented by the ARPC.

APPENDIX B

TERMS OF REFERENCE — 2012 REVIEW

Reporting to the Minister for Employment and Financial Services and Superannuation, the Hon Bill Shorten MP, by 30 June 2012, Treasury is to inquire into:

- the need for the *Terrorism Insurance Act 2003* (the Act) to continue in operation;
- the relationship between premiums (charged by the ARPC) and the resulting pool of funds raised by the ARPC, and the impact of retrocession (taken out by the ARPC) on the pool and the terrorism insurance scheme more generally;
- whether the current levels and structure of industry retention which applies to each entity which reinsures with the ARPC are appropriate;
- whether the scheme should be refined in any other way to improve its operation; and
- the payment of a dividend by the ARPC to the Commonwealth.

Any recommendations made by Treasury must be consistent with:

- the need to encourage private sector involvement;
- ensuring that risk transferred to the Commonwealth is appropriately priced and that the Commonwealth is compensated by those benefiting from the assistance;
- encouraging the re-emergence of the commercial market for terrorist risk cover; and
- global conditions.

In conducting the Review, Treasury is to seek submissions from, and if appropriate, consult further with, key stakeholders including: various private sector stakeholders, including reinsurers and specialist reinsurance brokers, and peak bodies representing the general insurance, banking, broking and

property industries; State and Territory governments; and other Australian government agencies, including the ARPC.

Review of the Terrorism Insurance Act 2003

Consultation Paper

February 2012

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1. Introduction

The *Terrorism Insurance Act 2003* (the Act) established the Australian Reinsurance Pool Corporation (ARPC) as a statutory authority to administer the terrorism insurance scheme. Both the scheme and the ARPC began operations on 1 July 2003.

The Act requires that at least once every three years, the Minister must prepare a report that reviews the need for the Act to continue in operation. Reviews were completed in June 2006 and June 2009. A further review is now to be completed by April 2012 (the '2012 Review').

As part of the 2012 Review, Treasury will undertake targeted consultation with a range of stakeholders. The Government is seeking your feedback and comments on the proposal outlined in this consultation paper of whether there is a need for the Act to continue in operation. It will also provide an opportunity for stakeholders to consider other elements of the scheme to determine whether they are appropriate in the current context.

Terms of Reference for the 2012 Review are at Attachment A.

2. The Terrorism Insurance Act 2003: Background

Australia's terrorism insurance scheme (the scheme) was established to minimise the wider economic impacts that flowed from the withdrawal of terrorism insurance in the wake of the terrorist attacks in the United States of America on 11 September 2001. The lack of affordable terrorism insurance at the time forced commercial property owners, banks, superannuation funds and fund managers to assume their own terrorism risk, as existing policies expired and renewal policies explicitly excluded terrorism cover. The Government was concerned that the lack of terrorism insurance for commercial property and infrastructure would lead to a reduction in financing and investment in the Australian property sector, with subsequent wider negative economic impacts.

In May 2002, the Government announced that it would act to protect the Australian economy from the negative effects of the withdrawal of terrorism insurance cover, and that any intervention should be consistent with the need to:

- maintain, to the greatest extent possible, private sector provision of insurance;
- ensure that risk transferred to the Commonwealth is appropriately priced to minimise the impact on the Commonwealth's financial position, and to

ensure that the Commonwealth is compensated by those benefiting from the assistance ;

- allow the commercial insurance and reinsurance markets to step back in to the market when they are able (that is, ensuring an appropriate exit strategy for government); and

- be compatible with global solutions.

The scheme was established under the *Act.* The Act established a scheme for replacement terrorism insurance cover for commercial property and associated business interruption, and also established the ARPC as a statutory authority to administer the scheme. Both the scheme and the ARPC began operations on 1 July 2003.

The Act operates by overriding terrorism exclusion clauses in ‘eligible insurance contracts’ (pertaining to commercial property) by rendering them void. Insurers may then reinsure their additional terrorism risk with the ARPC, in which case a premium is payable to the ARPC.

The ARPC will pay out claims for loss of, or damage to, eligible property in the event of a Declared Terrorist Incident (DTI). The Minister, in consultation with the Attorney-General, determines whether a terrorist act has happened in Australia. Once that determination has been made, the Minister will declare a DTI under section 6 of the Act.

Layers of the Scheme

Insurance companies that write eligible insurance contracts may reinsure with the ARPC the risk of claims for eligible terrorism losses. Premium and investment income continue to build the ARPC’s funds available to cover claims from a DTI.

In the event of a DTI, the ARPC is able to meet claims through a combination of reserved funds and retrocession, which it purchases each year. These currently provide $3.426 billion in cover. Should these sources of funds be exhausted, the Commonwealth provides a $10 billion guarantee to the scheme.

If the Treasurer considers that the total amounts paid or payable by the Commonwealth under the guarantee would exceed $10 billion, then the announcement of a DTI must be accompanied by the specification of a reduction percentage. The effect of a reduction percentage is to reduce the amounts payable under eligible insurance contracts. The reduction percentage may be varied, but only by making it smaller.

3. Need for the Act to Continue

The scheme was established as an interim measure and is intended to operate only while terrorism insurance cover is unavailable commercially on reasonable terms. At the time it was established, the Government also considered that uncertainty in the market made it impossible to stipulate the details or timing of its windup. As a result, the Act requires that at least once every three years after the start-up time, the Minister must prepare a report that reviews the need for the Act to continue in operation. Reviews were completed in June 2006 and June 2009.

The 2006 Review concluded that there was still a need for the Act to continue in operation, subject to a further review within three years. The Review considered that, while the market for terrorism insurance had recovered somewhat since the scheme was introduced, insufficient terrorism insurance was available commercially on reasonable terms.

The 2009 Review considered the need for the Act to continue in the context of the international terrorism insurance market which had been characterised by improvements in the availability and affordability of terrorism insurance, subject to certain limitations. Despite these improvements, the Review found that there was still insufficient commercial capacity to meet demand for terrorism insurance at affordable rates. While global capacity for reinsurance of terrorism risk had improved for national pooled arrangements, there was insufficient capacity at reasonable prices for individual risks.

The 2012 Review of the Act is seeking to determine whether sufficient private market capacity in the provision of terrorism insurance at commercially affordable rates is currently available.

Questions:

To what extent, if any, is terrorism cover available in the private market on commercially reasonable terms?

If there is little or no private market capacity for terrorism insurance in Australia, what are the barriers to its provision and is the presence of the ARPC hindering the development of commercial terrorism insurance in Australia in any way?

4. Pricing and Retrocession

The Act gives the ARPC the power to collect premiums for the reinsurance it provides. Insurers who seek terrorism reinsurance through the ARPC pay premiums to the ARPC, although insurers may choose to reinsure with

providers other than the ARPC. Insurers may pass on the cost of reinsurance to their policyholders through premiums, although this is a commercial decision for the insurer.

Premiums paid to the ARPC replicate commercial arrangements where insurers choose to buy reinsurance. The premium charged for reinsurance is determined by Ministerial Direction and are calculated as a percentage of the underlying premium. Reinsurance premiums therefore automatically reflect changes in underlying premiums such as increasing sums insured, which are a matter for each insurer to determine.

The premiums are set based on the level of risk. There are three broad tiers based on geographic location and identified by postcode. Table 1 below demonstrates the breakdown of tiers and the geographical location to which they relate.

Table 1: Tier based on geographical location

Tier	Explanation
A	Covering the CBD areas of Australian cities with a population of over one million (Sydney, Melbourne, Brisbane, Perth and Adelaide)
B	Covering the urban areas of all state capital cities and cities with a population over 100,000 (Sydney, Melbourne, Brisbane, Perth, Adelaide, Gold Coast, Canberra, Newcastle, Central Coast of New South Wales, Wollongong, Hobart, Geelong, Sunshine Coast of Queensland, Townsville and Darwin)
C	Postcodes not allocated to either tier A or B Any property not on the mainland of Australia or Tasmania, but within the coastal sea of Australia

Reinsurance premiums are calculated as a percentage of the premium written by the reinsured that is attributable to the eligible insurance contract, in accordance with the following table.

Table 2: Premium structure for reinsurance

Class of insurance	Tier	Initial rate from 1 October 2003 (per cent)
Commercial property	A	12
	B	4
	C	2
Business interruption	A	12
	B	4
	C	2
Public liability		Nil

When the scheme was first established, it was considered that reinsurance premiums of between 2 and 12 per cent of underlying commercial property insurance premiums would be adequate to build the pool (reserves for claims) and would not be a significant cost to smaller commercial property owners if passed on by insurers. As potential public liability costs are difficult to quantify, in the absence of a significant claim on the scheme there is no initial premium payable for reinsurance of terrorism risk in this class of insurance. However, in the event of a significant claim on the scheme, reinsurance premiums would be required to be paid for public liability insurance. In the event of a significant claim on the scheme, premiums payable to the ARPC would increase to enable the ARPC to finance its liabilities and rebuild the pool.

The premium levels have remained unchanged since 1 October 2003.

Once the ARPC has accounted for administration costs, the Act provides no direction on how it is to use the premiums collected. In 2002, the then Treasurer indicated that the ARPC should initially use premiums to fund a $300 million pool, which it reached during 2006-07. Neither the Act nor the Ministerial Direction specifies that premiums should change once the pool reaches $300 million.

Recommendations of the 2006 Review

The 2006 Review considered the issue of continued premium collections at existing rates in the context of suggestions from some stakeholders that the ARPC should cease collecting premiums once the pool reached $300 million. To encourage greater involvement of the commercial sector in providing terrorism risk cover, the Review recommended that:

- the ARPC be required to continue charging premiums for reinsurance at the current rates, subject to further review within three years; and
- once the pool reaches $300 million, the ARPC have the discretion to determine whether to use premiums to build the pool further, purchase reinsurance for the scheme or undertake a combination of the two.

The Government supported these recommendations.

After an investigation by the ARPC's Board of the availability of terrorism cover in the global reinsurance market and extensive negotiations, retrocession contracts were entered into with reinsurers from the Australian, European, Lloyd's and Bermudan markets. The retrocession was placed in excess of $300 million and gave the scheme additional capacity of $2.3 billion in the event of a DTI. The cover started on 31 December 2008.

Recommendations of the 2009 Review

Premiums

The 2009 Review once more considered the issue of the adequacy of the premiums collected by the ARPC and whether the ARPC should cease to collect premiums — given that the pool had at that stage exceeded $300 million.

The 2009 Review found that taxpayers' interests need to be protected, given the sizeable risk the Commonwealth had taken on in the form of the $10 billion indemnity provided to the scheme. Additionally, to allow the Government's eventual withdrawal (given that it was designed as a temporary scheme), the Review noted that the scheme needed to be structured in such a way as to avoid stifling the emergence of the commercial market and to encourage private sector involvement to the greatest possible extent. The Review concluded that the ongoing collection of premiums was central to achieving both these outcomes, because if premium collections ceased, the Government would receive no compensation for providing a financial service through the ARPC, and removing the price from a service that is provided at a cost would be artificial and highly anti-competitive, making it impossible for commercial reinsurers to compete with the ARPC.

The review noted that the $300 million was an initial target for the size of the pool rather than an amount at which the pool should be capped, and that capping the pool would expose taxpayers to greater risk, producing inequitable outcomes for existing policyholder.

Capping the scheme (for example at $300 million) would reduce the real value of the pool over time, as it would not keep track of higher sums insured and greater numbers of policies insured with the pool. The Review noted that this would reduce the overall sufficiency of the scheme, including the Commonwealth's $10 billion indemnity. A pool that was less reflective of property values, risk and any increase in the number of policies reinsured with the ARPC would mean that the Commonwealth's $10 billion indemnity would cut in sooner, depending on the value of claims against the pool, potentially exposing taxpayers to greater risk.

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

The 2009 Review also concluded that if premiums ceased to be charged, new insurers and new policyholders would be treated inequitably, paying nothing for a service for which existing insurers and policyholders had made a significant contribution.

The 2009 Review supported no change to premiums levels as they were already competitive and reducing premiums would limit the ability of commercial insurers to compete. Furthermore, a reduction in premiums would only be feasible if the terrorism risk associated with insured properties had reduced, which had occurred since the scheme's introduction.

Overall, the 2009 Review found that premiums should continue to be charged at current rates, allowing the pool of funds available to the ARPC to grow in line with the increase in property values and risks assumed by the Government. Accordingly, there has been no change to premium levels charged by the ARPC since the 2009 Review.

Questions:

Is the ARPC's pricing adequately reflecting the risks it bears from its terrorism reinsurance program?

Is the ARPC's pricing in any way impeding the private market from offering terrorism insurance in Australia?

Retrocession

The 2009 Review also considered how, in the event the ARPC continues to build the pool, the funds from the pool could be used to enhance the financial stability of the scheme and provide increased protection to insureds and the Australian Government through the purchase of retrocession.

The review found that the purchase of retrocession would increase the effectiveness of the pool through;

- giving the scheme additional capacity in the event of a terrorist incident,
- lessening the likelihood of a reduction percentage being required;
- improving the financial stability and liquidity of the scheme, and enhancing its credibility, thereby encouraging commercial involvement in the scheme and the terrorism insurance market more generally; and
- reducing the Commonwealth's exposure to losses in excess of the pool.

The Review also found that while retrocession premiums would slow the growth of the pool (through the payment of premiums by the ARPC to retrocessionaires), the benefits of the retrocession arrangements to the scheme, as well as to insurers and the Commonwealth, outweighed the costs. The purchase of retrocession was also widely supported by stakeholders in the context of the Review. As such, the Review recommended that the ARPC investigate using premium income to purchase further retrocession for the scheme.

In addition to recommendations for the ARPC to maintain premiums at current rates and consider purchasing additional retrocession capacity, the 2009 Review also recommended that the relationship between premiums and the pool, and the impact of retrocession on the pool and the scheme more generally, be further considered in the context of the 2012 Review.

The ARPC has purchased retrocession every year since 2009. It initially provided cover of $2.3 billion, and was subsequently renewed and increased in December 2009 to $2.6 billion and again in 2011 to $2.75 billion.

The ARPC renewed its retrocession program on 31 December, 2011 for 2012. There are several changes to the structure of the program, most notably the use of ARPC's reserves in co-reinsuring the program. This has resulted in the schemes capacity increasing by $11 million while reducing its retrocession premium costs from $81 million for the 2011 program to $71.7 million for 2012.

Question:

Does the continued purchase of retrocession represent an appropriate use of the ARPC's surplus funds?

5. Industry Retention

One of the underlying principles of the scheme is that it should be designed to allow the re-emergence of the commercial market for terrorism risk cover. Raising retention levels requires insurers to retain a greater amount of terrorism risk, which they can decide to self-insure or seek to commercially reinsure. Either course of action increases private sector involvement in the provision of terrorism risk cover. Increasing retentions also increases the relative attractiveness of commercial terrorism cover, and may marginally reduce the cost of retrocession coverage for the scheme since insurers would be retaining a larger amount of risk at a lower layer of the scheme, which tends to be more expensive to reinsure.

The 2006 Review recommended that retention levels under the scheme be increased in order to make them more comparable with commercial

reinsurance and similar schemes overseas and to require commercial insurers to assume more terrorism risk. As a result, the *Treasurer to Australian Reinsurance Pool Corporation (Premiums) Direction 2007* required retentions to be increased in three increments, as set out below. The last of the retention increases came into effect on 1 July 2009.

Table 3: Annual insurer and industry retentions

Date	Annual insurer retention		Maximum industry Retention per incident
	Minimum	**Maximum**	
Occurring before 30 June 2007	Nil	The lesser of $1 million or 4 per cent of fire and ISR premiums collected	$10 million
1 July 2007 to 30 June 2008	$100,000	The lesser of $1 million or 4 per cent of fire and ISR premiums collected	$25 million
1 July 2008 to 30 June 2009	$100,000	The lesser of $5 million or 4 per cent of fire and ISR premiums collected	$50 million
Occurring after 30 June 2009	$100,000	The lesser of $10 million or 4 per cent of fire and ISR premiums collected	$100 million

The retention figures above represent the annual aggregate retention to be applied during the same retention period to each individual entity which reinsures with the ARPC, regardless of whether the entity is a subsidiary of a larger company which also reinsures with the ARPC. The Explanatory Memorandum to the *Terrorism Insurance Bill 2003* reinforces the idea that it was the Government's intention that a separate retention be applied to each individual entity which reinsures with ARPC. Item 1.1 of the Revised Explanatory Memorandum states that the retention will be set 'per insurer' and item 3.38 describes the retention for 'each insurer that reinsurers with the ARPC'.

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

Questions:

Is the current level and structure of retentions which apply to individual entities which reinsure with the ARPC appropriate?

Is the overall industry retention per incident appropriate? Would increasing this retention encourage insurers to seek out reinsurance privately? Would there be capacity available to individual insurers, and should they seek it?

6. Payment of Dividends to the Commonwealth

Since its inception, the terrorism insurance scheme has been backed by a Commonwealth guarantee of the ARPC's liabilities in the amount of $10 billion. From the outset, it was anticipated that the ARPC would compensate the Commonwealth for providing the guarantee.[30] This is consistent with general government policy to be compensated for any risk it assumes, where possible, and consistent with many other jurisdictions with similar government-backed schemes, which require payment of regular dividends.

No fees or dividends have to date been paid by the ARPC to the Commonwealth. No fees were paid in the early years of the scheme as the ARPC commenced with minimal funds and was expected to build a pool of cash reserves, with an original target of $300 million, later adjusted up to the current $375 million. However, current assets exceed $700 million, and coupled with the retrocession program and Commonwealth guarantee the size of the scheme now exceeds $13 billion.

Any decision to require payment of dividends by the ARPC to the Commonwealth would take into consideration a range of factors including the current capacity of the scheme and its ongoing sustainability in determining the appropriate amounts and timing for any payments for the risk assumed through the guarantee.

Question:

If the Government required the ARPC to pay a dividend to the Commonwealth, are there additional factors the Government should consider?

30 See, for example, *Terrorism Insurance Bill 2003, Revised Explanatory Memorandum*, paragraph 2.2. Express provision was also made for the payment of dividends generally in section 38 of the Act.

ATTACHMENT A

Terms of Reference — 2012 Review of the *Terrorism Insurance Act 2003*

Reporting to the Minister for Employment and Financial Services and Superannuation, the Hon Bill Shorten MP, by 30 June 2012, Treasury is to inquire into:

- the need for the *Terrorism Insurance Act 2003* (the Act) to continue in operation;
- the relationship between premiums (charged by the ARPC) and the resulting pool of funds raised by the ARPC, and the impact of retrocession (taken out by the ARPC) on the pool and the terrorism insurance scheme more generally;
- whether the current levels and structure of industry retention which applies to each entity which reinsures with the ARPC are appropriate; and
- whether the scheme should be refined in any other way to improve its operation.

Any recommendations made by Treasury must be consistent with:

- the need to encourage private sector involvement;
- ensuring that risk transferred to the Commonwealth is appropriately priced and that the Commonwealth is compensated by those benefiting from the assistance;
- encouraging the re-emergence of the commercial market for terrorist risk cover; and
- global conditions.

In conducting the Review, Treasury is to seek submissions from, and if appropriate, consult further with, key stakeholders including: various private sector stakeholders, including reinsurers and specialist reinsurance brokers, and peak bodies representing the general insurance, banking, broking and property industries; State and Territory governments; and other Australian government agencies, including the ARPC.

APPENDIX D

CONSULTATION WITH STAKEHOLDERS

As part of the 2012 Review, Treasury sought submissions from key stakeholders, and in some cases consulted further with those stakeholders, including:

Private sector

Aon Australia

Australian Bankers' Association

Australia New Zealand Banking Group

Chartis Australia Insurance

Commonwealth Bank of Australia

CHU

Insurance Council of Australia

Littlewoods Services

Lloyd's Australia

General Reinsurance Australia

Guy Carpenter and Company Australia

Munich Reinsurance Australia

National Australia Bank

National Insurance Brokers Association

Property Council of Australia

Reinsurance Group of America

Strata Communities Australia

Swiss Reinsurance Company

Westpac Banking Corporation

Willis Reinsurance Australia

Zurich Financial Services Australia

State/Territory government agencies

Department of Premier and Cabinet (NSW)

Department of Premier and Cabinet (Vic)

Department of the Premier and Cabinet (Qld)

Department of the Premier and Cabinet (WA)

Department of the Premier and Cabinet (SA)

Department of Premier and Cabinet (Tas)

Chief Minister's Department (ACT)

Department of the Chief Minister (NT)

Australian Government agencies

Australian Government Actuary

Australian Prudential Regulation Authority

Attorney-General's Department

Australian Reinsurance Pool Corporation

Department of Finance and Deregulation

Department of Prime Minister and Cabinet

Reserve Bank of Australia

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