Australian Government
The Treasury

TSY/AU

# 2021 Triennial Review of the Terrorism Insurance Act 2003

Consultation paper

July 2021

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# Consultation Process

## Request for feedback and comments

Interested parties are invited to comment on the issues raised in this paper by 30 July 2021.

The purpose of this consultation paper is to seek comments on whether there continues to be market failure in the private sector supply of terrorism insurance as well as whether other aspects of the scheme remain appropriate in the current context.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted. All information (including name and address details) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails are not sufficient for this purpose. If you would like only part of your submission to remain confidential, please provide this information clearly marked as such in a separate attachment.

Legal requirements, such as those imposed by the Freedom of Information Act 1982, may affect the confidentiality of your submission.

## Further consultation process

The Treasury will also consult broadly with industry, community representatives and other interested parties on the topics discussed in this consultation paper.

### Closing date for submissions: 30 July 2021

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# Introduction

## Background

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 was introduced to correct a market failure in commercial property insurance, which occurred in the wake of the events of September 11, 2001. At the time, the inability of portfolio managers and building owners to obtain cover for high-value properties because of terrorism, threatened to constrain commercial property and infrastructure development and thus distorted investment and portfolio allocation decisions.

However, the Act was established as an interim measure, intended to operate only while terrorism insurance cover was commercially unavailable on reasonable terms. Accordingly, the Act requires that at least once every three years, the Minister must review the need for the Act to continue in operation. The Government has completed five reviews of the Act between 2006 and 2018, with each recommending the scheme continue.

### Overview of 2018 Triennial Review

The 2018 Triennial Review found that in the absence of the Act, there would likely be a significant market failure in the terrorism insurance market. The estimated global commercial market capacity available for Australian terrorism reinsurance was considered insufficient to cover against large, but possible, terrorism incidents. Several reinsurers indicated they would find it difficult to participate in the Australian terrorism insurance market without a mechanism like the ARPC.

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

Lastly, the review found that the current scope of the scheme, the approach to declaring a terrorism incident and the pricing of the scheme remain appropriate.

## Approach and next steps

The Government is seeking your feedback on the questions outlined in this consultation paper by 30 July 2021 When drafting your submission, please note that you may answer all the discussion questions raised or, alternatively, only the questions that are relevant to you. Treasury will also undertake targeted consultation with a range of stakeholders.

Following consultation, the Treasury will develop advice for Government consideration based on stakeholder feedback.

All submissions will be published on the Treasury website unless they have been marked as confidential.

Terms of Reference for the 2021 Review can be found in Attachment A.

# Scope of the Review

## Terrorism reinsurance functions

Previous reviews completed in 2006, 2009, 2012, 2015 and 2018 have each found there was insufficient terrorism insurance available on commercially reasonable terms, and concluded that the Act should continue in operation, subject to further review in no more than three years.

The 2018 Review noted that the estimated global commercial market capacity available for Australian terrorism insurance is in the order of $4 billion. With this capacity predominantly deployed into the Australian market through the ARPC's retrocession program.

The Review found that capacity remains well short of the level of cover required to protect against large, but possible, terrorism incidents. Modelling suggested that this level of commercial capacity was insufficient to cover against a maximum single event loss from a conventional blast—an event which the Act was designed to protect against. The 2018 review also noted that broader market capacity would likely drop in the absence of the ARPC for reasons including:

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

### Should the terrorism reinsurance scheme continue?

This Review seeks feedback into whether private market capacity and appetite for the provision of terrorism insurance has improved sufficiently in the past three years to provide coverage at commercially affordable rates.

#### Questions

1. To what extent, if any, is terrorism cover available in the private market on commercially reasonable terms?
2. If there is insufficient 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?

# Cyber terrorism resulting in property damage

Currently excluded causes of property damage under the Terrorism Insurance Act include, nuclear events, acts of war, radiological damage and cyber-attacks.

The 2018 Review considered the issue of whether to include cyber terrorism causing damage to property in the scheme. At the time, it found that there was no evident market failure for cyber terrorism insurance in relation to physical property damage. In support of that finding, it found that:

- The underlying risk was considered low. The Australian Cyber Security Centre considered terrorist groups' use of offensive cyber capabilities to be limited. Terrorist groups lack the technical sophistication to threaten Australia's security using cyber means at this time.
- A cyber insurance market was rapidly emerging. Cyber insurance was the fastest growing sector of the Australian commercial insurance market, with coverage increasingly incorporated into business insurance packages or sold as an individual product.
- Market gaps may exist, but they do not necessarily represent a market failure. New risks not previously contemplated can fall between existing classes of commercial insurance products or may be reflective of a belief amongst consumers coverage does not demonstrate value. The 2018 Review noted industry had been proactive in seeking to underwrite the risk and exploring how it could fill market gaps.

In March 2020, the ARPC released a research report on cyber terrorism causing physical property damage in Australia, which drew from work it commissioned from the Organisation for Economic Co-operation and Development and Cambridge University's Centre for Risk Studies. The report identified a market gap for cyber terrorism insurance where the attack results in physical damage to commercial property, and that this has the potential to cause substantial losses. However, it also found that the probability of a cyber terrorism incident causing property damage remains remote.

## Should the Scheme be extended to include cyber terrorism causing physical property damage?

Similar to the previous review, the 2021 Review will consider whether a sufficient rationale has emerged to include cyber terrorism causing physical property damage within the Scheme. In line with the original intention of the Scheme, which aimed to ameliorate a market failure, the Review will consider the inclusion of cyber terrorist acts that results in physical property damage, such as damage to buildings or physical infrastructure.

### Questions

3. To what extent, if any, is cover for cyber terrorism resulting in physical property damage available in the private market on commercially reasonable terms?

4. If there is insufficient private market capacity for cyber terrorism causing physical property damage insurance in Australia:

4.1 What are the barriers to its provision?

4.2 How would the presence of the ARPC impact the development of commercial terrorism insurance in Australia?

4.3 Are there international examples of market or policy responses to cyber terrorism causing physical property that are applicable to the Australian context?

# Cyclone and Related-Flooding Reinsurance Pool

On 4 May 2021, the Australian Government announced its intention to establish a reinsurance pool covering the risk of property damage caused by cyclones and cyclone-related flood damage. The pool would seek to improve the accessibility and affordability of insurance for households and small businesses in cyclone-prone areas, which are mainly located in northern Australia.

The ARPC would administer the pool, which would operate from 1 July 2022. A Treasury Taskforce will consult with industry and community representatives to inform a decision on the reinsurance pool's final design.

## How might the ARPC's terrorism reinsurance pool functions interact with its new functions?

The ARPC's new role to operate a cyclone and related-flood insurance pool may pose challenges and opportunities for its terrorism reinsurance functions. As part of the Review, the Taskforce will closely consider the ARPC's strategic settings to ensure that they remain appropriate.

### Questions

5. Are there any changes in the governance, administration and resourcing of the terrorism reinsurance pool or the Terrorism Insurance Act that should be amended in light of potential interactions with the proposed cyclone and related-flood damage reinsurance pool?

# Attachment A

## Terms of Reference

The Terrorism Insurance Act 2003 (the Act) established a scheme for replacement terrorism insurance coverage for commercial property and associated business interruption. The Act also established the Australian Reinsurance Pool Corporation (ARPC) as a statutory authority to administer the scheme. Both the scheme and the ARPC began operations on 1 July 2003.

The scheme was established as an interim measure to address a specific market failure in the private provision of terrorism insurance. The scheme is intended to operate only while terrorism cover is unavailable commercially on reasonable terms. As a result, s. 41 of 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 this Act to continue in operation.”

Previous reviews were completed in 2006, 2009, 2012, 2015 and 2018. Each review concluded that the Act should continue in operation, subject to further review in no more than three years.

To allow for completion of the Review by 12 December 2021, Treasury will report to the Minister on:

- whether there continues to be market failure in the private sector supply of terrorism insurance, and consequently whether there is a need for the Act to continue;
- whether the governance, administration and resourcing of the scheme remain appropriate, including interactions between the Cyclone Reinsurance Pool and the Terrorism Reinsurance Pool; and
- whether the risk of cyber terrorism causing physical property damage should be included in the scheme.