EXPLANATORY STATEMENT

Select Legislative Instrument 2007 No. 107

Issued by the Authority of the Treasurer

Terrorism Insurance Act 2003

Terrorism Insurance Amendment Regulations 2007 (No. 1)

Section 43 of the *Terrorism Insurance Act 2003* (the Act) provides that the Governor-General may make regulations prescribing matters required or permitted by the Act to be prescribed, or necessary or convenient to be prescribed for carrying out or giving effect to the Act. The Act established the framework for the Government's terrorism insurance scheme and the Act effectively deems all eligible insurance contracts to include terrorism risk cover.

Subsection 7(2) of the Act allows the regulations to prescribe insurance contracts to which the Act does not apply. Schedule 1 of the *Terrorism Insurance Regulations 2003* (the Principal Regulations) lists excluded insurance contracts for the purposes of subsection 7(2).

Section 41 of the Act requires that a review of the need for the Act to continue in operation be undertaken at least every three years after commencement. The first review was completed by 30 June 2006 and released by the Treasurer on 15 September 2006. The Government has agreed to all of the review's recommendations. The new Regulations implement one recommendation of the review.

The new Regulations amend the Principal Regulations to ensure that the scheme applies to commercial insurance contracts providing cover to public authorities of the Commonwealth, a State, the Northern Territory or the Australian Capital Territory. Previously, the scheme covers commercial insurance relating to government business enterprises and local government but not commercial insurance relating to other public authorities. Its application to insurance for all public authorities addresses this inconsistency and help the ARPC to further diversify the risk it assumes.

In addition, the new Regulations prevent the scheme from applying to insurance contracts underwritten by the Northern Territory or the Australian Capital Territory. This ensures consistency with the objectives of the scheme which does not apply to insurance contracts underwritten by the Commonwealth or a State. However, this does not prevent the scheme from applying to insurance contracts underwritten by a government owned insurer, such as the Northern Territory's Territory Insurance Office, that competes in the private market and requires reinsurance from the private market or the ARPC.

The new Regulations are a legislative instrument for the purposes of the *Legislative Instruments Act 2003*.

Regulation Impact Statement (RIS) prepared for the purposes of the review under section 41 of the Act. That RIS is at Attachment A to this explanatory statement.

Consultation on the regulation is detailed at page 53 of the RIS.

The new Regulations commence on 1 July 2007. A transitional clause means that each commercial insurance contract for a public authority will be included in the scheme at the time, on or after 1 July 2007, that the contract commences or is renewed.

Terrorism Insurance Act Review: 2006

Regulation Impact Statement

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OVERVIEW

The *Terrorism Insurance Act 2003* (the Act) requires the Treasurer to prepare a report that reviews the need for it to continue in operation at least once every three years. The report was prepared as a result of a review conducted by the Treasury during the first half of 2006. The report recommended that the Act continues in operation, subject to a further review in no more than three years.

The review also offered the opportunity to consider refinements to the scheme that might enhance its effectiveness or facilitate greater involvement of the commercial market over time.

This Regulation Impact Statement (RIS) provides background on the Act and the terrorism insurance scheme established under it.

This RIS then considers a number of issues that were raised by stakeholders regarding the scope of the scheme. Options to refine the scope of the scheme and their associated costs and benefits are considered below.

This RIS also considers how the scheme could be refined to encourage greater commercial market involvement in providing terrorism risk cover. Options to refine the scheme to encourage greater commercial market involvement and their associated costs and benefits are considered below.

This RIS then summaries the consultation processes used and then describes how the agreed changes will be implemented and reviewed.

BACKGROUND

ROLE OF INSURANCE AND REINSURANCE

Insurance plays an important role in the economy. It allows for the transfer of risk to those best placed to manage it. This risk transfer allows individuals and businesses to undertake activities that would otherwise not take place, or could not continue to operate in the same way, if the insurance industry did not exist.

Accordingly, the insurance industry's safety is important, not only for the protection of individual policyholders, but also for the stability of, and confidence in, the wider economy.

Insurers write coverage directly with the individual or business purchasing a policy and then redistribute the risk through investment and reinsurance arrangements.

Insurers are usually under no obligation to seek reinsurance. However, in practice, insurers rely heavily on reinsurance to manage their risk. Reinsurance is a global business that allows insurers to limit their risk exposure on an individual policy, or on a group of policies, and to underwrite more and larger individual risks than they would otherwise be willing or able to cover.

WITHDRAWAL OF TERRORISM INSURANCE

Before the 11 September 2001 attack on the World Trade Center, many Australian and overseas insurers considered the risks posed by terrorism to be negligible, so its cover was implicitly included in most insurance contracts, as part of general 'all-risks' cover.

The events of 11 September 2001 fundamentally changed the way the world — and insurers — looked at terrorism risk. Insurers and reinsurers sustained previously unimaginable losses. Insurers realised that their coverage of landmark buildings included terrorism insurance virtually free of charge.

While this was acceptable when terrorism risk seemed remote, the risk was no longer remote.[1]

This led both insurers and reinsurers to be more precise and detailed in specifying and pricing the risks and liability underwritten in their insurance policies. They were also more cautious in covering risks they had previously seen as routine.[2]

Reinsurance payments to insurers for the World Trade Center losses came in the wake of other expenses, triggered by a series of catastrophic natural disasters over the previous decade, and portfolio losses from stock market declines.[3] During 2001 and 2002, the reinsurance industry's capital contracted sharply. This hampered the industry's ability to cover large and difficult-to-insure risks.

Most reinsurers decided to either reduce their offers of terrorism cover drastically or to stop covering the risk. This limited the ability of insurers to spread their exposure to catastrophic terrorism risk. Without the ability to spread the risk of catastrophic losses, insurers sought to reduce their own exposures by reducing—in line with the reinsurers—the cover they provided.

Economic impact of the withdrawal of terrorism cover

In the face of these changes in the insurance industry, many commercial policyholders faced steep price increases or were unable to obtain terrorism coverage because of exclusions or the tighter underwriting environment. In turn, the lack of coverage had the potential to halt real estate transactions and construction projects and reduce employment.[4]

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1 Swiss Reinsurance Company 'Innovating to insure the uninsurable' *Sigma* 4/2005, 10. <http://www.swissre.com/INTERNET/pwswpspr.nsf/fmBookMarkFrameSet?ReadForm&BM=../vwAllbyIDKeyLu/bmer-6gtaaw?OpenDocument>

2 OECD *Policy issues in insurance No. 9: Terrorism risk insurance in OECD countries*, Paris 2005, 232. <http://www.libertymutual.com/omapps/ContentServer?cid=1078445945404&pagename=CorporateInternet%2FDocument%2FShowDoc&c=Document>

3 Howard Kunreuther and Erwann Michel-Kerjan 'Terrorism insurance 2005' *Regulation* Spring 2005, 45. <http://grace.wharton.upenn.edu/risk/downloads/regulationmagazineHK-EMK.pdf >

4 R. Glenn Hubbard and Bruce Deal 'The economic effects of Federal participation in terrorism risk' 14 September 2004. <http://www.rer.org/pdf/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=4637>

With a large pool of assets uninsured for terrorism risk, the uncertainty facing financiers and investors had the potential to result in broad economic impacts, by delaying commencement of investment projects and altering portfolio management decisions. Economic theory suggests that a significant reduction in lending leads directly to a reduction in economic growth.[5]

In Australia, there was a risk that financiers would be unprepared to provide finance to some large projects or large-scale infrastructure if terrorism cover was withdrawn and the new assets were exposed to an uninsurable risk.

In 2002, the Treasurer noted in Parliament that such risks had already materialised in the United States, with one survey estimating that US$15.5 billion worth of construction projects had been suspended because of a lack of comprehensive insurance cover.[6]

A survey conducted by the Association of Risk and Insurance Managers of Australasia of its 500 members in early 2002 indicated that more than 40 per cent of companies had had terrorism excluded from policies renewed after 11 September 2001 and 64 per cent of those yet to renew had been told they would not get terrorism cover.[7]

Pressure for government intervention from the insurance, property and banking industries became stronger in early 2002. There were calls for the Australian Government to commit itself to providing a financial safety net by being the insurer of last resort in claims arising from terrorist acts. Banks and property owners lobbied the Government to provide some sort of terrorism insurance cover.

ESTABLISHMENT OF THE TERRORISM INSURANCE SCHEME

The Australian Government determined in May 2002 that it should act to ensure the availability of terrorism insurance cover. The Australian Government was concerned that the lack of comprehensive terrorism cover for commercial property or infrastructure would lead to less financing and investment in the Australian property sector and that this would subsequently have wider economic impacts.

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5 Geoff Atkins and Tim Pitt 'Terrorism insurance' 26(3) *Australian and New Zealand Institute of Insurance and Finance Journal* June/July 2003, 19.

6 Commonwealth of Australia Parliamentary Debates (Hansard) House of Representatives 12 December 2001, 10,261.

7 Parliament of Australia Parliamentary Library *Bills Digest No. 110 2002-03 Terrorism Insurance Bill 2002*. <http://www.aph.gov.au/library/pubs/bd/2002-03/03bd110.htm>

A number of governments around the world also reached the same conclusion and instituted government terrorism insurance schemes.

The Treasurer announced that the Government would offer remainder insurance for losses above the cover available from individual insurers, possibly after a pooling arrangement.

The Government decided that any intervention should be consistent with:

- the need to maintain, to the greatest extent possible, private sector provision of insurance;
- the need to ensure that risk transferred to the Commonwealth is appropriately priced to minimise the impact on the Commonwealth's financial position, and to ensure that the Commonwealth is being compensated by those benefiting from the assistance;
- the need to allow the commercial insurance and reinsurance markets to step back in when they are able (that is, ensuring an appropriate exit strategy for Government); and
- the need to be compatible with global solutions.[8]

OUTLINE OF THE TERRORISM INSURANCE SCHEME

The Government established the terrorism insurance scheme through the *Terrorism Insurance Act 2003* (the Act), as a temporary measure to replace terrorism insurance coverage for commercial property and associated business interruption losses and public liability claims.

The Government's objective is to operate the scheme only while terrorism insurance is unavailable commercially on reasonable terms. As such, the Act requires a report to be produced at least every three years that reviews the need for the Act to continue in operation.[9]

Insurers had excluded liability for terrorism losses by including clauses to that effect in their insurance contracts. The Act, which commenced on 1 July 2003, overrides those terrorism exclusion clauses in 'eligible insurance contracts' to

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8 Treasurer's press release 31 of 21 May 2002. <http://www.treasurer.gov.au/tsr/content/pressreleases/2002/031.asp>.

9 Section 41.

the extent the losses excluded are 'eligible terrorism losses' arising from a 'declared terrorist incident'.[10]

The Act makes these terrorism exclusion clauses ineffective for all classes of insurance included in the scheme and 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.

In general, the terrorism insurance scheme covers eligible insurance contracts applying to all commercial property in Australia and associated business interruption losses and public liability claims.

Businesses with insurance will benefit from the scheme if a terrorist incident affects them through either property damage or business interruption.

The scheme covers contracts that insure:

- 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 such property; or
- liability of the insured that arises out of the insured being the owner or occupier of eligible property.[11]

The Act defines 'eligible property' to be property located in Australia, namely:

- 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.[12] The *Terrorism Insurance Regulations 2003* (the Regulations) prescribe tangible property in, on or under the seabed.[13]

Cover is also available for Commonwealth and state business enterprises as well as Commonwealth owned airports leased commercially. Farms can also benefit from cover, if they hold insurance against business interruption.

10 Section 8.
11 Subsection 7(1).
12 Section 3.
13 Regulation 4.

The scheme does not cover contracts for such matters as workers' compensation, residential property and contents insurance, builders' warranty insurance, marine insurance, aviation insurance, motor vehicle insurance, life insurance, health insurance, private mortgage insurance, medical indemnity insurance and professional indemnity insurance.[14]

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

The ARPC covers eligible terrorism losses for any declared terrorist incident covered by an eligible insurance contract where the insurer has a reinsurance agreement with the ARPC. 'Eligible terrorism losses' do not include a loss or liability arising from the hazardous properties of nuclear fuel, material or waste.[15]

Policyholders pay their premiums to the insurer in exchange for the insurer taking on their risks. Similarly, the premium an insurer pays to the ARPC is in exchange for the ARPC taking on the insurer's terrorism risk.

The ARPC's premium is a percentage of the underlying premium. Insurers may in turn pass on the cost of this reinsurance to their policyholders through their premium. This is a commercial decision for the insurer.

Premiums paid to the ARPC are neither a tax nor a levy. The premium replicates the commercial arrangements insurers make if they choose to buy commercial reinsurance.

The ARPC's reinsurance rates fall within three broad tiers and are set by Ministerial direction. The tiers are based on geographic location and identified by postcode. Central Business District areas of Australian cities with a population of over one million (that is, Sydney, Melbourne, Brisbane, Perth and Adelaide) form one tier, with a reinsurance rate of 12 per cent of the underlying premium. Urban areas of all state capital cities and cities with a population of over 100,000 (including Sydney, Melbourne, Brisbane, Perth, Adelaide, Gold Coast, Canberra, Newcastle, the Central Coast of New South Wales, Wollongong, Hobart, Geelong, the Sunshine Coast of Queensland, Townsville and Darwin) form the next tier, with a rate of 4 per cent of the

14 Regulation 5 and Schedule 1 of the Regulations.

15 Section 3.

underlying premium. The third tier comprises areas not allocated to those other tiers, with a rate of 2 per cent of the underlying premium.[16]

While the reinsurance rate is not indexed, it reflects any change in the underlying premium and thereby also reflects the risks factored into that premium. The Australian Government does not set the underlying premium the insurer charges its policyholders. The total amount the insurer charges a policyholder is a matter for each insurer to determine.

The terrorism insurance scheme provides a six-layer model that will operate to spread the cost of any claims.

Layer	Element
First layer	Policyholder's liability for some risk through a possible excess or deductible.
Second layer	Retention of some risk by insurers.
Third layer	Pool of premiums paid to the ARPC for reinsurance, initially targeted to be approximately $300 million.
Fourth layer	Commercial line of credit for up to $1 billion funded by the pool of premiums.
Fifth layer	Commonwealth Government indemnity for up to $9 billion.
Sixth layer	Possible liability for some risk by policyholders, through the operation of the reduction percentage or policy limits.

The scheme operates to provide reinsurance for those risks covered by the policyholder's insurance. For example, over and above any excess or deductible, if a policyholder has a policy limit of $10 million but incurs a loss of $12 million, the scheme will cover the policyholder's losses up to $10 million. Alternatively, if the policy covers some perils, such as fire, but the declared terrorist incident relates to biological contamination, then the scheme will not cover perils that are not covered in the policyholder's insurance contract.

A commercial insurance policyholder retains some risk. First, the insurance policy may set an excess or deductible. Second, if the Treasurer considers that a declared terrorist incident, when taken together with other claims on the scheme, will have a cost for the Commonwealth (and therefore all taxpayers) greater than $10 billion, the Treasurer must declare a reduction percentage, which will reduce the amount payable by the insurer to its policyholders.[17] That is, a policyholder will not receive a full payout. Third, the policyholder would also bear some liability if the upper limit of their policy was lower than their actual loss, as noted above.

16 *Treasurer to Australian Reinsurance Pool Corporation (Premiums) Direction 2003.*
17 Subsection 6(7).

The policyholder's possible risk retention forms the first and last layers of the six-layer model.

Insurers also retain some risk, as required by a Ministerial direction. The maximum risk retained by the insurer is the lesser of $1 million per year or 4 per cent of gross written premium for the fire and industrial special risks (ISR) class per insurer per year, with a maximum retention by the industry of $10 million per event.[18] If the insurer does not wish to hold this level of risk the insurer may seek additional cover in the commercial market. The $1 million retention factor is not indexed. The insurer's risk retention forms the second layer of the scheme.

The ARPC charges insurers premiums in return for reinsuring the risk of claims for eligible terrorism losses. Premiums paid by insurers for reinsurance build up a pool that forms the third layer of the scheme (currently on track to reach the initial target of $300 million). The pool is currently supplemented by a bank line of credit of $1 billion provided by ABN Amro, underwritten by the Commonwealth (the fourth layer in the scheme). There is also a Commonwealth indemnity of $9 billion (the fifth layer of the scheme).

These arrangements will provide aggregate cover of up to $10.3 billion once the pool reaches the initial target of $300 million.

If the bank line of credit or Commonwealth indemnity were called on following a declared terrorist incident, it would be possible to increase the ARPC's premiums to recoup losses and refund the bank and the Commonwealth for any outlays. For example, the Treasurer may raise the top rate charged for reinsurance from 12 per cent to a maximum of 36 per cent and the bottom rate from 2 per cent to a maximum of 6 per cent, in order to ensure that the ARPC can rebuild the pool and repay the line of credit and indemnity. In that regard, the Ministerial power of direction in section 38 of the Act, that allows the Treasurer to set the 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

For the terrorism insurance scheme to apply, the insurance policy must exclude terrorism cover and the insurer must have reinsurance from the ARPC. If there is no exclusion, the commercial insurer provides the cover.

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18 *Treasurer to Australian Reinsurance Pool Corporation (Risk Retention) Direction 2003.*

Under the Act, the Treasurer must declare a terrorist incident to make the insurer's exclusion ineffective. Following a declared terrorist incident, the scheme will provide cover, in excess of the maximum insurer and industry retentions, to insurers with a reinsurance agreement with the ARPC that have paid the relevant premiums.

In declaring a terrorist act to be a 'declared terrorist incident', the Treasurer would seek the views of the Attorney-General. The Treasurer's declaration would be a legislative instrument for the purposes of the *Legislative Instruments Act 2003*.

As noted above, if the Treasurer considers that an incident, when taken together with other claims on the scheme, will cost the Commonwealth more than $10 billion, the Treasurer must also declare a reduction percentage. This would have the effect of limiting the level of cover, by reducing the amount payable by the insurer to the policyholder.

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

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

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

Need for the Act to continue in operation

As noted above, the Act requires a report to be produced at least every three years to determine if there is a need for the Act to continue in operation. A brief survey of the review's findings is provided below.

Global terrorism insurance market

Although there are a range of views on the current capacity of the market to absorb terrorism risk, there is a good deal of consistency. Aon, an international broker of insurance and reinsurance, notes that the market has softened somewhat since 2001. It attributes some of this softening to the loss of business to government solutions and pools.

According to Aon, a substantial stand-alone terrorism market has developed since 11 September 2001. While the property all-risks insurers are unwilling to offer terrorism coverage, Aon suggests that the stand-alone market has sufficient capacity to fill most gaps in property insurance, at a price.

In 2004, the stand-alone market had about US$1.2 billion in capacity to cover terrorism risks, according to Aon.[19] In mid-2005, Marsh (another international broker) estimated terrorism market capacity outside of major metropolitan areas at approximately $1.4 billion.[20] Aon's later measurement in March 2006 put market capacity at around US$1.3 billion.[21]

Aon points out that the insurance of risks located in capacity 'hot spots' is an exception to this softening market. Certain cities have become terrorism capacity hot spots. For example, insurance capacity is very limited in midtown and downtown Manhattan, and in Brussels, and this has driven up prices. In some areas, demand is so great that the insurers can sell whatever capacity they have left at high rates.[22]

Marsh also notes that the amount available for a specific risk can vary significantly, depending on the risk's location, the insurer's accumulated exposure and the concentration of exposures in the given area. It suggests that, in major metropolitan areas with high levels of concentrated risk, the terrorism market capacity is more limited and much more expensive.[23]

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19 'Critics say U.S. shouldn't renew terrorism insurance. Federal terror insurance under fire' *CBS MarketWatch* 11 September 2004. <
http://www.alwayson-network.com/comments.php?id=P5835_0_6_0_C>

20 Marsh *Marketwatch: Terrorism Insurance 2005*, 2.
<http://www.marsh.dk/files/Marketwatch_Terrorism_Insurance_2005.pdf>

21 Aon Limited *Stand-alone terrorism insurance market update* March 2006.
<http://www.aon.com/uk/en/pdfs/standalone_terrorism.pdf>.

22 Ibid.

23 Marsh *Marketwatch: Terrorism Insurance 2005*, 2.
<http://www.marsh.dk/files/Marketwatch_Terrorism_Insurance_2005.pdf>

Also, insurers may apply restrictions to 'trophy' buildings, sports stadiums, entertainment theme parks and transportation hubs, which are perceived to be particularly vulnerable to terrorism.[24]

Aon notes that the series of hurricanes in 2005 will also affect property reinsurance renewals. The reinsurers selling this property reinsurance are the same group that selectively offers terrorism reinsurance, so they will be less inclined to include additional perils, such as terrorism.

Australian terrorism insurance market

While the ARPC sees the market for terrorism insurance as having recovered somewhat, it suggests that the market is not yet at the stage where it has eliminated the need for the scheme. According to the ARPC, there is no evidence that the reinsurance industry is offering widespread terrorism cover with meaningful capacity at a reasonable price.

The Insurance Council of Australia understands that the withdrawal of terrorism cover continues. It suggests that, where it is possible to obtain cover, it is expensive and only available in isolated cases. The Insurance Council of Australia considers that the need for the Act and the ARPC remains.

The Property Council of Australia notes that there was a significant market failure when the scheme was established and — based on information from brokers and insurers — there is still considerable market failure in insurance for terrorism risks. It suggests that the Act is vital to the long-term financial protection of Australia's property sector and those who rely on it, and that it should continue for the foreseeable future.

The Australian Bankers' Association believes that the withdrawal of terrorism insurance cover continues. It suggests that, where terrorism insurance cover is available, it is expensive and many restrictions apply, which in effect means it is only available in quite limited circumstances.

Despite its expense, the demand for terrorism cover remains. Secured lenders in real estate continue to require commercial borrowers to buy full terrorism coverage. Demand is also driven by corporate governance requirements imposed by the *Corporations Act 2001* and, for listed companies, by the Australian Stock Exchange. Additionally, trustees have fiduciary duties developed from the common law and may also be subject to specific obligations, such as those in the *Superannuation Industry (Supervision) Act 1993*.

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24 Aon, above n 22.

Need for the Act to continue

In short, there is still a need for the Act to continue in operation because it is unlikely that adequate terrorism insurance for the Australian market will be available in the near future.

Given the cyclic nature of insurance and reinsurance, ongoing monitoring for changes is also required. At the time of any future review, there may be a range of options for either encouraging sufficient capacity to return through a staged reduction in Government intervention, or through ongoing Government intervention.

REFINING THE SCOPE OF THE SCHEME

ISSUES

Some stakeholders raised a number of issues regarding the scope of the terrorism insurance scheme, as detailed below.

Insurance for public authorities

The Australian Reinsurance Pool Corporation (ARPC) note that there is some concern that the scheme covers commercial insurance relating to some, but not all, public authorities.[25]

The *Terrorism Insurance Act 2003* (the Act) and *Terrorism Insurance Regulations 2003* (the Regulations) declare that insurance contracts underwritten by the Australian Government and by the states are not 'eligible insurance contracts'.[26] This is because these governments self-insure. In addition, for thoroughness, the scheme also generally excludes contracts of insurance that cover public authorities. except where the public authority is a government business enterprise (GBE) or a 'local governing body established by or under a law of a State, other than a body whose sole or principle function is to provide a particular service, such as the supply of electricity or water'.[27]

Some stakeholders argue the Regulations create an anomaly in the treatment of commercial insurance for public authorities. For example, commercial insurance relating to a state owned GBE that supplies water (such as Melbourne Water) will have access to the scheme, while commercial insurance relating to a local government utility whose sole purpose is to supply water (such as the Barwon Region Water Authority), is excluded.

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25 For the purpose of this discussion, a 'public authority' means a public authority of the Commonwealth, a State, the Northern Territory or the Australian Capital Territory or an instrumentality or agency of the Crown in right of the Commonwealth, a State, the Northern Territory or the Australian Capital Territory. However, it does not include the Crown in right of the Commonwealth, a State, the Northern Territory or the Australian Capital Territory or a Minister or Department of the government of the Commonwealth, a State, the Northern Territory or the Australian Capital Territory.

26 See subsection 7(3) of the Act and item 8 of Schedule 1 of the Regulations.

27 Items 8(d), (e) and (f) of Schedule 1 of the Regulations.

The example of local government utilities demonstrates an inconsistency, being that commercial insurance provided for some public authorities is allowed access to the scheme while commercial insurance for other public authorities is not. Whether a public authority is in or out of the scheme depends on the insurance cover it obtains and also how the body was established and its function.

This means that public authorities that are not a GBE or a local government bear their own terrorism risk or have to seek commercial terrorism cover.

The issue is whether the scheme should apply to commercial insurance provided for all public authorities, regardless of how the public authority is established or what its function is.

Insurance for high-rise residential buildings

The Australian Bankers' Association, the Insurance Council of Australia and the Property Council of Australia raised concerns about the exclusion of high-rise buildings used solely or predominantly for residential purposes from the scheme.

To determine whether an insurance policy relates to a commercial or residential building (and hence whether the Act applies), an insurer must categorise the building. If a policy is issued in relation to a building that is predominately commercial, then that policy is considered to be an 'eligible insurance contract' under the Act. However, if a policy is issued in relation to a building that is predominantly residential, then that policy is not considered to be an 'eligible insurance contract'.[28]

This means that insurance for high-rise residential buildings and high-rise buildings used predominantly for residential purposes are excluded from the scheme. As a result, owners of such buildings must bear their own terrorism risk or seek commercial terrorism cover.

The risk of a terrorist incident affecting high-rise residential buildings is similar to the risk of a terrorist incident affecting a high-rise commercial building.

Should a terrorist incident affect a predominantly residential high-rise building it may adversely impact the property market. In particular, it may be difficult for developers to sell residences in high-rise buildings following a terrorist incident, where such residences are unable to obtain terrorism cover.

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28 See item 2 of Schedule 1 of the Regulations.

To pre-empt this potential negative impact on the Australian property market, it has been suggested that insurance contracts relating to predominantly residential high-rise buildings should be included within the scope of the scheme.

Access to the scheme by non-insurers

The ARPC notes that some businesses are concerned that the scheme does not cover insurance-like products offered by discretionary mutual funds (DMFs).

DMFs offer an insurance-like product. However, in any provision of cover to its members a DMF retains discretion as to whether or not to give protection in respect of a particular claim.

The discretionary nature of such products means that DMFs do not need to become APRA-authorised insurers under the *Insurance Act 1973*.[29] In turn, DMFs do not write or issue contracts of insurance and they therefore do not fall within the scope of the *Terrorism Insurance Act 2003*.

Members of DMFs may own or occupy 'eligible property' and could potentially suffer 'eligible terrorism losses' in a 'declared terrorist incident'. However, because DMFs do not issue 'eligible insurance contracts', the Act does not apply.

If a member of a DMF suffered an 'eligible terrorism loss' and there were terrorism exclusions in the cover offered by the DMF, the 'eligible property' would be without cover unless the DMF member arranged alternative commercial insurance cover for terrorist incidents. In other words, without commercial cover, DMF members must bear their own terrorism risk.

The issue is whether insurance-like products, such as those offered by DMFs, warrant coverage under the Act.

OBJECTIVE

The objective is to ensure the scheme minimises significant detrimental economic impacts that may have arisen as a result of any further withdrawal of terrorism risk cover.

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29 The Australian Government has accepted the recommendations of the *Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers* and, through a December 2005 discussion paper, is considering the implementation of those recommendations, including the possibility of applying prudential regulation to DMFs.

A secondary objective is to ensure that the scheme applies consistently to all commercial property and infrastructure that was originally intended to benefit from the scheme.

Options

Options for addressing the above issues are considered below, including a 'no change' option.

Option 1 — Retain the status quo

There would be no change to the current scope of the scheme.

Option 2 — Ensure the scheme covers insurance for public authorities

Change the scope of the scheme to allow access to commercial insurance provided for all public authorities.

Option 3 — In addition to option 2, ensure the scheme covers insurance for residential high-rise buildings

Expand the scope of the scheme to cover insurance for high-rise buildings used predominantly for residential purposes.

Option 4 — In addition to option 3, ensure the scheme covers DMF products

Amend the Act to expand the scope of the scheme to allow access to insurance-like products offered by non-insurers, such as DMFs.

COST-BENEFIT ANALYSIS

Option 1 — Retain the status quo

Option 1 impact summary		
Stakeholder	**Costs**	**Benefits**
Property owners	Nil	Nil
Insurance Industry	Nil	Nil
ARPC	Nil	Nil
Australian Government	Nil	Nil
DMFs	Nil	Nil
DMF Members	Nil	Nil

Costs

Insurance for public authorities

Commercial insurance for a range of public authorities is excluded from the operation of the scheme despite insurance for GBEs and local government (but not local government utilities) having access. The public authorities excluded from the scheme are required to accept the risk of a terrorist incident or seek insurance from their respective governments or buy commercial terrorism insurance.

In relation to public authorities that are local government utilities, it is not apparent that their exclusion from the scheme was intended. The Explanatory Statement for the *Terrorism Insurance Amendment Regulations 2003 (No. 1)* indicates that the policy intent has always been that local government property would be covered by the terrorism insurance scheme. The scheme excluding commercial insurance relating to local government utilities appears to conflict with this policy intent.

Insurance for high-rise residential buildings

Should a terrorist incident occur that impacted a predominantly residential high-rise building the property sector may be adversely affected. It could become difficult for developers to sell residential apartments in high-rise buildings if residents were unable to obtain cover for terrorism risks. This is not a current cost, but is outlined here as a potential cost.

Owners of apartments in high-rise buildings may not be covered for losses arising from a terrorist incident. However, there is some commercial insurance cover available for predominantly residential buildings.

Whether an insurance policy is an 'eligible insurance contract' under the scheme depends on whether the property it relates to is predominantly commercial or residential. As such, some commercial property remains uninsured against terrorism risks because some businesses are operating in predominantly residential buildings. These businesses may be required to assume all related terrorism risks or seek commercial cover, while other businesses (including possible competitors) are covered by the scheme for such risks.

The total value of business assets that are not covered by the scheme because they are in a building that is predominately residential is not currently known.

It is important to note that this potential cost does not appear to be currently impacting on the ability of the property sector to continue operating efficiently and is not causing a detrimental impact on the Australian economy.

Access to the scheme by non-insurers

To the extent that DMFs are excluding terrorism risks from their contracts, members of DMFs are at risk if they have not arranged for commercial cover for terrorism risks. Should a terrorist incident occur that affected property owned by DMF members those members would incur all of the losses.

However, some DMFs have been able to reinsure terrorism risks for members commercially. Assuming the DMF would exercise its discretion in its members' favour, these DMF members have been able to transfer some terrorism risks to the insurance market.

The total value of assets owned by DMF members and the number of DMF members who are not covered for terrorism risks is not known.

Another cost for DMF members is that commercial cover for terrorism risks costs more than reinsuring such risks with the ARPC. There are also greater limits and restrictions on this cover.

Benefits

Insurance for public authorities

There is some commercial insurance and reinsurance cover for terrorism risks. If public authorities are seeking commercial insurance cover, this may encourage further growth in the commercial insurance and reinsurance market for terrorism risks.

Those public authorities that insure with their respective government are covered for terrorism risks.

Insurance for high-rise residential buildings

The current regime was structured to ensure that insurance on the construction of high-rise property would have access to the scheme, regardless of whether such property would ultimately be used for residential or commercial purposes. It is not until the building is completed and the residences are sold that insurance on that structure is no longer considered an 'eligible insurance contract'.

This arrangement means that developers are largely unaffected by the withdrawal of terrorism risk cover. Developers have been able to continue constructing high-rise residential buildings. The ability to obtain finance has not been affected, even where a lender requires the project be insured against all risks, including terrorism.

Further, the risks to the financial system are limited as the scheme covers the interests of lenders who debt finance large building projects.

Lenders also limit and diversify the amount of risk they assume when lending to buyers of apartments in residential high-rise buildings, by limiting the amount of finance they provide in relation to any one building.

There is no evidence that the withdrawal of terrorism insurance for residential property has impacted the willingness of lenders to provide finance for apartments in high-rise buildings.[30]

As noted in the following table, according to the Housing Industry Association Economics Group, from 2001-02 to 2004-05, unit commencements (including high-rise apartments) were steady. Builders would not have started constructing new units if they considered it unlikely that they could sell them, recalling that most units are debt financed.

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30 ABS housing finance figures do not indicate substantial falls in the number of Australian dwellings financed from 2001 to now. However, the ABS figures do not differentiate between the types of dwellings for which finance is provided. See ABS series 5609.0 – *Housing Finance, Australia.* <www.abs.gov.au>.

Unit commencements in Australia[31]	
Period	**Unit commencements**
2001-02	47 992 units
2002-03	54 539 units
2003-04	52 331 units
2004-05	50 170 units

There is commercial insurance cover available for some residential buildings. Commercial terrorism cover is available in most cases if the residential building has a sum insured of less than $10 million (however, such cover may exclude losses caused by chemical, biological and nuclear attacks). If residential buildings are able to draw on existing commercial terrorism risk cover, it may encourage further growth in this market.

Just because the scheme does not cover residential buildings does not mean the Australian Government cannot provide assistance in a different form should a terrorist incident occur. The Government would be able to consider a number of options for support should a terrorist incident impact a residential building. There are also a number of existing arrangements in place for dealing with disasters and emergencies.

Access to the scheme by non-insurers

Some terrorism insurance is available commercially and certain DMFs have purchased cover for terrorism risks. This encourages further growth in the commercial insurance and reinsurance market for terrorism risks.

The ARPC and the Australian Government bear less risk than would be the case if DMF risks were included under the scheme. This means Australian taxpayers are subject to less risk.

DMFs structure their business to ensure that they are not subject to legislation applying to insurance companies and insurance products. If DMFs were allowed access to the scheme, but still did not have to abide by other regulation applying to insurance companies (such as the *Insurance Contracts Act 1984*), this may put DMFs at a competitive advantage to insurers.

31 Housing Industry Association Economics Group *Dwelling Unit Commencements, Australia.* <http://economics.hia.com.au>

The scheme was specifically designed to apply to insurance contracts. Changes to the scheme to take into account non-insurance products would add considerable complexity and cost.

Option 2 — Ensure the scheme covers insurance for public authorities

Option 2 impact summary		
Stakeholder	**Costs**	**Benefits**
Property owners (except public authorities)	Nil	Nil
Public authorities	Approximately 2-12 per cent increase on premiums.	Able to insure against all terrorism risks relating to property, business interruption and liability and at less cost than available commercially.
Insurance industry	Must provide terrorism cover for public authorities.	Nil
ARPC	Must provide reinsurance cover for insurers of public authorities.	Nil
Australian Government	Potentially liable for incidents affecting public authorities.	Nil

Costs

Insurance for public authorities

Under option 2, terrorism exclusions in commercial insurance policies covering all public authorities will have no effect. In the first instance, this means that insurers covering these public authorities will become liable for terrorism risks.

However, insurers could reinsure this risk with the ARPC. Insurers would be charged between 2 and 12 per cent of the underlying premium to reinsure terrorism risks with the ARPC.

Public authorities that purchase commercial insurance would face 'start-up' costs in educating themselves about this change, assessing its impact on the authority and making any necessary changes to systems and regular reports (such as annual financial accounts). The total 'start-up' cost for all affected public authorities would be likely to be in excess of $350,000 with an average cost per public authority of $7,000.[32]

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32 'Start-up' costs for public authorities are calculated on the assumption that there are 50 such authorities in Australia (there are at least 20 water utilities that would be affected) each of

Public authorities that purchase commercial insurance would also be likely to face increases in premiums of between 2 and 12 per cent, reflecting the likely choice by insurers to pass on the costs of reinsuring with the ARPC. Insurers may also charge a small amount for their administrative costs and any costs associated with having to retain risk under the scheme, for example, because this affects their capital requirements. However, these costs would still represent a cost reduction where the public authority currently holds more expensive commercial terrorism insurance cover.

Insurers providing commercial insurance to public authorities would face 'start-up' costs in educating themselves about this change, assessing its impact on their policyholders and their reinsurance arrangements, and making any necessary changes to systems and regular reports (such as annual financial accounts). The total 'start-up' cost for all affected insurers would be likely to be in excess of $1.65 million with an average cost per insurer of $15,000.[33]

For any insurer that did not already have a reinsurance agreement with the ARPC, there would also be the additional costs associated with the risk an insurer is required to retain under the scheme.

Benefits

Insurance for public authorities

The scheme would no longer differentiate between commercial insurance provided for GBEs and local government and commercial insurance provided for other public authorities. This would ensure consistency between commercially insured public authorities providing similar services, but established in different ways and with different functions.

Public authorities would no longer need to show that they are a GBE or a local government, only that they are commercially insured. The scheme would continue to exclude insurance underwritten by the Australian Government or State insurance.

By allowing public authorities access to the scheme, the ARPC would be able to further diversify its risk. The ARPC currently only reinsures insurance for

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which spends an average of $7,000 on these tasks (10 hours x $700 per hour labour costs for accounting, systems and administrative services).

[33] 'Start-up' costs for insurers are calculated on the assumptions that none of the approximately 110 foreign or captive insurers reinsuring with the ARPC (and who provide only approximately 5 per cent of reinsurance revenue) are insuring public authorities. However, it is assumed that all of the remaining 110 insurers are insuring public authorities with each spending an average of $15,000 on these tasks (10 hours x $1,500 per hour labour costs for actuarial, accounting, legal, systems and administrative services).

public authorities where they are established as a GBE or are a local government.

A policy intent of the scheme was to cover commercial insurance for local government property. This option would allow, amongst other things, commercial insurance for local government utilities access to the scheme. This would ensure that the above policy intent is met. As a result, local government utilities would be covered by the scheme in relation to terrorism risks and they would not have to seek more expensive commercial terrorism insurance or carry their own risks. As a result, terrorism risks associated with local government utilities would, in a large part, be transferred from a small pool of rate payers to a larger pool of insurance policyholders and all Australian taxpayers.

Option 3 — In addition to option 2, ensure the scheme covers insurance for residential high-rise buildings

Option 3 impact summary		
Stakeholder	**Costs**	**Benefits**
Property owners (except public authorities and those in residential high-rise buildings)	Nil	Nil
Public authorities	Approximately 2-12 per cent increase on premiums.	Able to insure against all terrorism risks relating to property, business interruption and liability and at less cost than available commercially.
Property owners in residential high-rise buildings	Approximately 2-12 per cent increase on premiums.	Able to insure against all terrorism risks relating to property, business interruption and liability and at less cost than available commercially.
Insurance industry	Must provide terrorism cover for public authorities and residential high-rise buildings.	Nil
ARPC	Must provide reinsurance cover for insurers of public authorities and residential high-rise buildings. Residential risks not diversified.	Nil
Australian Government	Potentially liable for incidents affecting public authorities and residential high-rise buildings.	Nil

Costs

Insurance for high-rise residential buildings

Under option 3, risk would be transferred from policyholders insuring predominantly residential high-rise buildings to the ARPC and the Australian Government. This risk is ultimately borne by Australian taxpayers.

Terrorism exclusions in insurance policies covering predominantly residential high-rise buildings would have no effect. In the first instance, this means insurers covering such property would become liable for the terrorism risks.

However, insurers could reinsure these risks with the ARPC. Insurers would be charged between 2 and 12 per cent of the underlying premium to reinsure terrorism risks with the ARPC.

Insurers can choose to, and are likely to, pass the costs of purchasing reinsurance onto policyholders. Assuming the insurer does pass reinsurance costs on, policyholders in predominantly residential high-rise buildings would be required to pay between 2 and 12 per cent more on their insurance premiums. Insurers may also charge policyholders a small amount to reflect administration costs and any costs associated with having to retain risk under the scheme, for example, because this affects their capital requirements. However, these costs would still represent a cost reduction where a policyholder in a high-rise residential building currently holds more expensive commercial terrorism insurance cover.

A cost for the insurer is that it would be required to retain a proportion of the terrorism risks under the ARPC reinsurance agreement. Should an incident occur in relation to a predominantly residential high-rise building, option 3 would require insurers to be liable to pay for some or all of the damage, depending on the size of the incident and whether the insurer has already met their retention for that year.

There is no evidence currently available indicating that the withdrawal of terrorism cover from policies covering predominantly residential high-rise buildings is affecting the sale of such property. In fact, as outlined earlier, the Housing Industry Association Economics Group found that from 2001-02 to 2004-05, unit commencements were steady.

There is some commercial insurance cover available for predominantly residential buildings. Option 3 may discourage this market from expanding, which contrasts with an original policy intent of the scheme.

If insurance for high-rise residential buildings was allowed access to the scheme, there are a number of consequences that require consideration.

If the ARPC only reinsured insurance relating to high-rise residential property (which is considered to be a higher risk) without also assuming responsibility for lower risk residential property, the overall risk assumed by the scheme would increase. If the ARPC is unable to diversify the risk it assumes in relation to residential property, this may impact on the sustainability of the scheme.

To diversify its risk in a manner consistent with the scheme's treatment of commercial property, all insurance relating to residential property would need to be included in the scheme. This would mean that all residential property holders in Australia that had home insurance would contribute to the scheme, whether they lived in a high-rise apartment or not. In other words, the insurance purchasing owners of 97 per cent of Australia's private dwellings would be contributing funds that are most likely to benefit the owners of less than 3 per cent of all dwellings, that is, the owners of apartments in 'high rise' residential buildings.[34]

In the financial year ending June 2005, insurers collected gross premium revenue of $3,250 million from homeowners.[35] If the terrorism insurance scheme applied to residential property (and assuming insurers passed on the costs of reinsuring with the scheme), this would involve an increase in the premiums that homeowners were required to pay. Even understating this increase by assuming that no homeowners would be charged 12 per cent for terrorism cover, total annual premiums would increase by at least $114 million.[36] Insurers may also charge a small amount for their administrative costs and any costs associated with having to retain risk under the scheme, for example, because this affects their capital requirements.

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34 At the 2001 Census there was 198, 626 flats, units or apartments in a four or more storey block (that is, a 'high rise'). At the same date, there were a total of 6,684,000 other occupied dwellings (that is, 'separate houses', 'semi-detached, row or terrace houses, town houses etc' and 'flats, units and apartments'). The 'high rise' flats, units or apartments (198,626) are only 2.86 per cent of all occupied dwellings (6,684,000 + 198,626): see table B18 in the ABS, *Census of Population and Housing: Selected Social and Housing Characteristics*, 2015.0, 2001. <http://www.ausstats.abs.gov.au/ausstats/subscriber.nsf/0/74B727D9E14BB247CA256DCC007F5048/$File/20150_2001%20(reissue).pdf>

35 Australian Prudential Regulation Authority, above n 1, 17. <http://www.apra.gov.au/Statistics/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=10520>

36 The *ABS 2006 Yearbook* (117) indicates that at 30 June 2004, 75 per cent of the population lived in urban areas (cities with a population greater than 100,000). Accordingly, if all insurance for residential property was covered by the scheme, 75 per cent of homeowners would be charged an additional 4 per cent (or more) on their home insurance premium for terrorism cover, a total increase of at least $97.5 million. The remaining 25 per cent of homeowners would be charged an additional 2 per cent on their home insurance premium for terrorism cover, an increase of $16.25 million.

This increase in premiums for homeowners would be used by insurers to purchase reinsurance from the ARPC. Insurers providing commercial insurance to homeowners would also face 'start-up' costs in educating themselves about this change, assessing its impact on there policyholders and their reinsurance arrangements and making any necessary changes to systems and regular reports (such as annual financial accounts). The total 'start-up' cost for all affected insurers would be likely to be in excess of $9.9 million with an average cost per insurer of $90,000.[37]

The scheme currently provides approximately $10.3 billion terrorism cover (made up of the reinsurance pool, which is initially targeted to be $300 million, a $1 billion line of credit and a $9 billion Commonwealth indemnity). If the scheme was expanded to cover additional major classes of property, $10.3 billion is less likely to be adequate to cover all terrorism risks.

This means that there would be a greater chance that reinsurance would be insufficient to cover all insured losses if a large terrorist incident was to occur in the future. In that regard, the Act requires the Treasurer to specify a reduction percentage if the total amounts payable by the Australian Government would be greater then $10 billion.[38] As such, there would be a greater chance that each claim would not be met in full.

If insurance for predominantly residential property was allowed access to the scheme, a question would also arise as to whether one or two pools would be necessary. If the existing pool was used, residential property owners would initially be covered by a pool to which they had not contributed premium. This would enable residential property owners to 'free ride' on those who had previously paid premiums that contributed to the building of the pool.

Benefits

Insurance for high-rise residential buildings

Option 3 would pre-empt and negate the potential impacts on the wider economy that may flow from possible reduced property sales after a terrorist incident impacted on a predominantly residential high-rise building. It would also reduce any impact on property developers (noting that insurance covering properties under construction is already included in the scheme, regardless of

37 'Start-up' costs for insurers are calculated on the assumption that none of the approximately 110 foreign or captive insurers reinsuring with the ARPC (and who provide only approximately 5 per cent of reinsurance revenue) are insuring homeowners. However, it is assumed that all of the remaining 110 insurers are insuring homeowners with each spending an average of $90,000 on these tasks (60 hours x $1,500 per hour labour costs for actuarial, accounting, legal, systems and administrative services).

38 Section 6.

whether the ultimate use of the property will be predominantly residential or commercial).

Owners of property in predominantly residential high-rise buildings would no longer have to assume responsibility for the potential liabilities associated with terrorism risks or seek commercial insurance cover.

Option 4 — In addition to option 3, ensure the scheme covers DMF products

Option 4 impact summary		
Stakeholder	**Costs**	**Benefits**
Property owners (except public authorities and those in residential high-rise buildings)	Nil	Nil
Public authorities	Approximately 2-12 per cent increase on premiums.	Able to insure against all terrorism risks relating to property, business interruption and liability and at less cost than available commercially.
Property owners in residential high-rise buildings	Approximately 2-12 per cent increase on premiums.	Able to insure against all terrorism risks relating to property, business interruption and liability and at less cost than available commercially.
Insurance industry	Must provide terrorism cover for public authorities and residential high-rise buildings.	Nil
ARPC	Must provide reinsurance cover for DMFs and insurers of public authorities and residential high-rise buildings. Residential risks not diversified.	Nil
Australian Government	Potentially liable for incidents affecting public authorities, residential high-rise buildings and DMF members.	Nil
DMFs	Must cover terrorism risks relating to commercial property, public authorities and residential high-rise buildings.	Nil
DMF members	Approximately 2-12 per cent increase on underlying contract price.	Able to obtain cover for all terrorism risks relating to property, business interruption and liability (subject to DMF discretion) and at less cost than available commercially.

Costs

Access to the scheme by non-insurers

Under option 4, risk would be transferred from DMFs, DMF members and commercial reinsurers to the ARPC, the Australian Government and hence to Australian taxpayers.

Terrorism exclusions in DMF products relating to commercial property, public authorities and predominantly residential high-rise buildings would have no effect. In the first instance, DMFs would become potentially liable for these terrorism risks.

However, DMFs could insure these risks with the ARPC. DMFs would be charged between 2 and 12 per cent of the underlying contract price to insure terrorism risks with the ARPC.

DMFs would face 'start-up' costs in educating themselves about this change, assessing its impact on their members and making any necessary changes to systems and regular reports (such as annual financial accounts). The total 'start-up' cost for all affected DMFs would be likely to be in excess of $3.15 million with an average cost per DMF of $45,000.[39]

A further cost for DMFs is that they would be required to retain a proportion of the terrorism risk under the ARPC insurance agreement.

DMFs could choose to, and are likely to, pass the costs of purchasing insurance onto DMF members. Assuming the DMF does pass insurance costs on, DMF members would be required to pay between 2 and 12 per cent more on their contracts. DMFs may also charge members a small amount to reflect administration costs and any costs associated with having to retain risk under the scheme. However, these costs would still represent a cost reduction where the DMF member holds more expensive commercial terrorism insurance cover.

DMFs have structured their businesses to avoid insurance-related regulation. A consequence of this is that they currently miss out on the benefits provided under the Act. Including DMFs in the scheme may put them at a competitive advantage to insurers, as they would continue to avoid insurance regulation but would nevertheless obtain benefits under the Act.

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[39] 'Start-up' costs for DMFs are calculated on the assumption that 70 DMFs insure with the ARPC and each spends an average of $45,000 on these tasks (30 hours x $1,500 per hour labour costs for actuarial, accounting, legal, systems and administrative services).

The scheme was specifically designed to apply to insurance contracts. Changes to the scheme to take into account non-insurance products would add considerable complexity and cost.

DMFs retain discretion over whether or not to pay a claim. However, the Act operates so that terrorism exclusions in insurance policies have no effect. The Act therefore could not be easily extended to cover DMF products. This is because, even if an exclusion in a DMF product was deemed to have no effect, DMFs still retain the discretion to refuse to pay a claim. This discretion would undermine the certainty the Act was designed to provide.

Hence, the Government would have to amend the Act to address this issue, involving costs to the Government. It may also involve costs to DMFs, as legislative changes would be likely to limit the discretionary nature of DMF products, at least in relation to terrorism risks. In other words, a DMF may no longer be able to use its discretion to refuse to pay a claim relating to terrorism. Of course, how much of a terrorism claim a DMF had to meet would depend on whether it had insured with the scheme and, if so, what its retention was.

Some terrorism risk cover is available commercially. DMFs that draw on existing commercial terrorism risk cover may be encouraging further growth in the commercial insurance market for terrorism risks. As a result, if DMFs were given access to the scheme, there would be reduced demand for commercial terrorism risk cover.

Benefits

Access to the scheme by non-insurers

Assuming a DMF exercised its discretion in its members' favour, the property of DMF members would be covered for terrorism risks. DMF members would not have to assume responsibility for the potential liabilities associated with terrorism risks or seek commercial terrorism risk cover. DMF members would be able to obtain terrorism risk cover at lower rates then currently offered by the commercial market.

Conclusion

Maintaining the status quo (option 1) involves retaining an inconsistency in the schemes treatment of insurance for commercial property and infrastructure. This is because commercial insurance relating to GBEs and local government is included in the scheme while commercial insurance relating to other public authorities is not. Given this inconsistency, the costs of option 1 outweigh its benefits.

In contrast, the benefits of option 2, which involves expanding the scheme to encompass commercial insurance for all public authorities, outweigh the costs. Option 2 is also consistent with the original general intention of the scheme to cover commercial property and infrastructure, other than that self-insured by the Commonwealth or the states.

Option 3 proposes that the scheme be expanded to allowing commercial insurance for predominantly residential high-rise buildings access to the scheme. Unlike commercial property, there is no evidence that the withdrawal of terrorism risk cover for predominately residential high-rise buildings has had any actual negative impact. Although option 3 would pre-empt and negate any potential economic effect that may flow if a predominantly residential building were impacted by a terrorist incident, the provision of this potential (future) benefit to the owners of such buildings would come at a greater actual (current) cost to the community as a whole.

Option 4 proposes to allow DMF products access to the scheme. This would involve a transfer of risk from DMF members to the ARPC and the Commonwealth and thus to Australian taxpayers. However, DMFs structure their business to avoid insurance regulation and it is this choice of structure that means the scheme does not apply to DMF products. To change the scheme to accommodate DMFs would be complex and costly. It would not necessarily increase certainty for DMF members. For these reasons, the costs associated with including DMF products in the scheme outweigh the benefits.

RECOMMENDATION

It is recommended that option 2 is implemented, which involves changing the scope of the scheme to cover commercial insurance provided in relation to all public authorities.

ENCOURAGING COMMERCIAL INVOLVEMENT

ISSUES

Stakeholders raised a number of issues relating to the method and level of premiums charged for reinsurance and retention levels. These issues are outlined below.

Collection of premiums

The *Terrorism Insurance Act 2003* (the Act) gives the Australian Reinsurance Pool Corporation (ARPC) the power to collect premiums for the reinsurance cover it provides. Premium rates have been set by Ministerial direction.[40]

Once the ARPC has accounted for administration costs, there are no specific requirements on how the ARPC is to use premiums collected. However, the Australian Government indicated that the ARPC should initially use premiums to fund a $300 million pool. This is what the ARPC is currently doing.

Neither the Act nor the Ministerial direction specifies that premium collections would change once the pool reaches $300 million. As such, the ARPC will continue to be required to collect premiums after the pool reaches $300 million.

This means that the 220 insurers that have reinsurance agreements with the ARPC would continue to pay premiums to the scheme and, in all likelihood, pass these costs on to policyholders.

The Australian Bankers' Association and the Property Council of Australia have suggested that the ARPC should cease collecting premiums once the pool reaches $300 million.

The issue is whether the ARPC should continue to collect premiums when the pool reaches $300 million (which is expected to occur within the next year).

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40 *Treasurer to Australian Reinsurance Pool Corporation (Premiums) Direction 2003.*

Retentions

As outlined above, insurers are required to retain some terrorism risk under the scheme.

Some stakeholders have noted that, by industry standards, the maximum insurer retention for the scheme is low. For example, many of Australia's large insurers retain considerably more than $10 million on property catastrophe treaties for any one event.

Other things being equal, if scheme retention levels are significantly lower than commercial reinsurance retention levels then it will be difficult for commercial reinsurers to compete with the ARPC. This will discourage greater commercial market involvement.

Further, setting retentions at a maximum of 4 per cent of an insurer's Australian gross fire and industrial special risks (ISR) premium also results in some insurers having very small retentions. For example, there are 124 insurers with maximum retentions between $1,000 and $100,000.

The issue is whether a minimum retention should be introduced and whether the maximum insurer and industry retentions should be reconsidered to bring greater parity between the scheme and existing commercial practice, thus increasing the equity of the scheme and encouraging greater participation of the commercial market.

Premiums on bundled insurance products

The ARPC notes that some businesses are concerned about the way reinsurance premiums are calculated for bundled insurance products.

As a marketing tool, insurers may offer clients the choice of multiple types of cover relating to a range of different commercial risks (for example, fire or accidental damage) together as one insurance policy. The different types of cover become different sections of a single bundled insurance policy, which is considered to be a single 'eligible insurance contract' under the Act.

If the different sections of an 'eligible insurance contract' contain terrorism exclusions, then the Act applies so that those exclusions have no effect. In turn, insurers can reinsure such terrorism risks with the ARPC, in return for paying a premium.

In accordance with the Ministerial direction, the ARPC is currently required to calculate reinsurance premiums based on the underlying premium of each 'eligible insurance contract'.

As a result, if a bundled policy is made up of some sections that exclude terrorism risks and some that do not exclude terrorism risks, the ARPC currently has no power to reduce the reinsurance premium it charges to take account of the lower risk it assumes because some terrorism risks are being borne by the insurer.

In other words, assuming the premium charged to each policyholder is the same, an insurer offering a policy that excludes all terrorism risks pays the same reinsurance premium to the ARPC as an insurer offering a bundled policy that excludes some, but not all, terrorism risks.

The issue is whether this may discourage insurers from covering certain terrorism risks under sections of a bundled insurance policy.

Objective

The objective is to encourage the commercial insurance market to be more involved in providing terrorism risk cover.

Options

Options for addressing the above issues are considered below.

Option 1 — Minimise scheme growth

Under option 1, the ARPC would stop collecting premiums when the pool reached $300 million, which was the initial goal for the pool set by the Australian Government in October 2002.

Option 2 — Maintain premium collection

Under option 2, there would be no changes made to the current premiums collected or retentions imposed. Once the pool reached $300 million, the ARPC would use its discretion to determine whether to use premiums to build the pool further, purchase reinsurance for the scheme or undertake a combination of the two.

Option 3 — In addition to option 2, increase risks assumed by the commercial insurance market

Under option 3, retention levels would be increased in three increments (with effect, respectively, from 1 July 2007, 1 July 2008 and 1 July 2009) as outlined in the table below:

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

Option 4 — In addition to option 3, only charge premium on risks excluded under a bundled policy

Under option 4, changes would be made so the ARPC would be required to charge reinsurance premiums only on those sections of the bundled policy that exclude terrorism risks. In other words, as long as the insurer could calculate the proportion of premium they charge on different sections of a bundled policy, the ARPC would charge the reinsurance premium only in relation to those sections that contained terrorism exclusions.

COST-BENEFIT ANALYSIS

Option 1 — Minimise scheme growth

Option 1 impact summary

Stakeholder	Costs	Benefits
Policyholders	Nil	Cut costs by $100m per year.[41]
Insurance industry	Nil	Nil
ARPC	Risk was priced at approximately $100m per year. The ARPC would assume this cost.	Nil
Australian Government	In the event of a terrorist incident, the likelihood of Australian Government contribution increases if the real value of the pool decreases over time.	Nil

Costs

Collection of premiums

If the ARPC ceased collecting premiums from insurers in return for providing reinsurance cover, it would be charging nothing for the risk that was transferred to it. It would be impossible for commercial reinsurers to ever compete with the ARPC.

As a consequence, commercial insurers currently offering terrorism cover in competition with the ARPC would withdraw this cover. It would also prove to be a disincentive for the commercial insurance market offering new terrorism cover. This would conflict with a principle of the scheme, being to encourage greater involvement of the commercial market.

Under option 1, after the pool reached $300 million, the ARPC would no longer be paid for covering terrorism risks. Ongoing risks of organisations and companies would effectively be assumed by all Australian taxpayers, who would not receive ongoing compensation from those benefiting from the assistance provided by the scheme.

Although it may be assumed that the value of the $300 million pool would increase due to the addition of investment returns, it is likely that over time the value of the scheme would not keep pace with the value of risks covered, especially taking into account increasing property values, the emergence of

41 ARPC estimate, assuming all things remain equal.

new risks, and possible increases in the number of policies reinsured with the ARPC. In particular, the real value of the $10 billion indemnity provided by the Commonwealth (made up of a $1 billion line of credit guaranteed by the Commonwealth and a $9 billion indemnity) would decrease over time.

This decrease in the overall value of the scheme would impose increased potential costs on commercial insurance policyholders. The greater the extent that the value of the cover provided by the scheme fails to keep pace with the value of the risks covered, the greater the chance that reinsurance would be insufficient to cover all insured losses if a large terrorist incident was to occur. (Recall that the Act requires the Treasurer to specify a reduction percentage if the total amounts payable by the Commonwealth would be greater then $10 billion.)[42] Ceasing to collect premiums therefore means there would be a higher probability that policyholders would not fully recover their losses from a declared terrorist incident.

Given the generous $10 billion indemnity currently provided by the Commonwealth, it is difficult to conceive of a sufficient case for it to be increased in the short or medium term to maintain the value of the scheme.

If premium collections stopped when the pool reached $300 million, new insurers and new policyholders would pay nothing upfront for terrorism risk cover. New insurers and policyholders would essentially get a ‘free ride’.

For example, if, after the pool reached $300 million, a terrorist incident caused $200 million damage to a building that belonged to a policyholder who had never contributed premium to the scheme, the pool would still cover that damage. Post event, all insurers (and then policyholders) would be charged premiums again to ensure the pool value returned to $300 million. This would affect all policyholders, both new and old.

In this scenario, policyholders that originally contributed premium to the scheme would pay approximately twice as much for covering losses arising from a terrorist incident as the new policyholder that was only first called on to pay premium after an incident occurred. Nevertheless, it would be this new policyholder who received the benefit of cover.

Insurers would also face ‘start-up’ costs in educating themselves about this change, assessing its impact on their policyholders and reinsurance arrangements and making any necessary changes to systems and regular reports (such as annual financial accounts). The total ‘start-up’ cost for all

42 Section 6.

affected insurers would be likely to be in excess of $3.3 million with an average cost per insurer of $15,000.[43]

Retentions

Current retention levels under the scheme are low compared to industry standards. For example, many large Australian insurers retain in excess of $10 million on property catastrophe treaties for one event.

Thirty four insurers are currently required to retain a nominal amount of $1 million of terrorism risk. The real value of this nominal amount will decrease over time. These insurers will retain less risk, and the ARPC, the Commonwealth and Australian taxpayers will assume more risk, as time progresses. The commercial involvement in the scheme will be less.

Premiums on bundled insurance products

The way the ARPC is required to collect premiums assumes that the ARPC reinsures all terrorism risks under a bundled insurance policy. However, this is not always true. Some insurers choose to cover certain terrorism risks under a bundled insurance policy. However, the ARPC cannot reduce the premium it charges to reflect the additional risk being borne by the insurer.

This could mean that a commercial insurance policyholder will effectively be charged twice in relation to cover for certain terrorism risks. That is, the policyholder pays the ARPC reinsurance premium (assuming it is passed on by the insurer) but also pays for cover provided by the insurer.

Alternatively, the insurer absorbs the costs associated with providing cover for certain terrorism risks. That is, the commercial insurance policyholder pays the ARPC reinsurance premium (assuming it is passed on by the insurer) and the insurer assumes certain risks at no charge.

If insurers exclude all terrorism risks from bundled insurance policies, they assume less risk and charge policyholders less premium. As such, option 1 discourages the commercial insurance market from providing limited terrorism risk cover in bundled insurance policies. This contrasts with a principle of the scheme, being to encourage greater involvement of the commercial insurance market.

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43 'Start-up' costs for insurers are calculated on the assumption that 220 insurers currently reinsured with the ARPC each spend an average of $15,000 on these tasks (10 hours x $1,500 per hour labour costs for actuarial, accounting, legal, systems and administrative services).

Benefits

Collection of premiums

Policyholders under the scheme would obtain terrorism cover for no charge, once the pool reached $300 million. There would be a total saving in the order of $100 million per year for commercial insurance policyholders.

In the commercial market, a premium would only be reduced if the risk had reduced or if the cost of replacing or repairing the underlying property had reduced. However, neither of these is true.

The threat of terrorism continues to be at the 'medium' level in Australia.

According to the Australian Bureau of Statistics, the cost of construction for non-residential buildings increased from 2003 to 2005.[44] The ABS Price Index of the Output of the General Construction Industry provides that from 2002-03 to 2003-04, construction costs increased by 9.03 per cent and from 2003-04 to 2004-05, construction costs increased by a further 9.87 per cent.

The ARPC would be able to cover its operating costs by using money earned through investing the premiums in the $300 million pool, and any remainder could be contributed to the pool.

Retentions

Insurers retain the same amount of risk, in nominal terms, as they do now. Those 34 insurers that retain a nominal risk of $1 million would retain less risk over time as the real value of $1 million decreases.

Premiums on bundled insurance products

The ARPC receives a small windfall gain on all bundled policies relating to commercial property that contain terrorism exclusions on some, but not all, of the risks covered by the policy. However, this would only be a benefit under option 1 until the pool reached $300 million, when the collection of premiums ceased.

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44 *ABS 2006 Yearbook*, figure 19.14, 515.

Option 2 — Maintain premium collection

Option 2 impact summary		
Stakeholder	**Costs**	**Benefits**
Policyholders	Nil	Nil
Insurance industry	Nil	Nil
ARPC	Nil	Nil
Australian Government	Nil	Nil

Costs

Collection of premiums

Under option 2, insurers would continue to pay for reinsurance at the current rates. Most insurers currently choose to pass these costs onto commercial insurance policyholders. As such, an ongoing cost is that policyholders would continue to pay for terrorism cover, which is currently set at 2 to 12 per cent of the underlying premium.

In total, and all things remaining equal, this would cost commercial insurance policyholders approximately $100 million per year. However, this is the cost of the ARPC covering terrorism losses across Australia in 2005-06 of up to $1,925,056 million.[45]

If the current premium levels charged by the ARPC underprice the terrorism risks that it is insuring, and the underlying value of insured property rises, then the difference between the current premium levels and the appropriate premium levels is borne by the ARPC, the Commonwealth and ultimately all taxpayers.

The scheme was set up because commercial insurers withdrew cover for terrorism risks. Because of this, it is arguable that premium levels have always been underpriced to some extent in that commercial insurers are unwilling to cover all risks that the ARPC is insuring at a comparable price.

However, some insurers are starting to again cover certain terrorism risks (for example, selected facultative terrorism cover on specific low-risk sites). This suggests that some commercial insurers believe they can compete with the premiums charged by the ARPC for some risks in selected locations.

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45 Total exposure of the ARPC for 2005-06.

Benefits

Collection of premiums

If the ARPC continues to collect premiums in return for providing reinsurance cover, then it will continue to charge a price against which commercial insurers and reinsurers can compete. This fits with a principle of the scheme, being that the risk transferred to the Australian Government is appropriately priced and that the Australian Government is compensated by those benefiting from assistance.

If the ARPC continues to collect premiums, this may encourage greater involvement of the commercial market. There is scope for commercial insurers to re-enter the market if they believe they can provide terrorism cover for less cost than the ARPC.

Under option 2, terrorism cover would continue to be affordable. Ensuring that terrorism cover was provided at an affordable level was a goal of the scheme.

Under option 2, once the pool reached $300 million, the ARPC could use additional premium income to increase the size of the pool or purchase reinsurance. Both of these options would reduce the risk that the Commonwealth, and hence Australian taxpayers, would be required to cover losses sustained if a terrorist incident was to occur.

The ARPC has advised that over the next three years, it expects to receive premium income of approximately $100 million per year. If the ARPC was to continue adding all premiums to the pool, by the time the scheme is next required to be reviewed in 2009, the pool would reach approximately $550 to $585 million.[46]

As the Commonwealth indemnity is effectively set in the Act at $10 billion, the cover available under the scheme will only grow if the pool grows. Option 2 would allow the ARPC to increase the size of the pool, or take out reinsurance cover for the scheme, or both. This would ensure that cover provided by the scheme grows in real terms.

Over time, property values will increase and the expected losses from business interruption will increase. A rise in the value of the total cover provided under

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46 ARPC estimate. Assumptions made in reaching the estimate are that:
- gross written premium collection rates remain constant over 2007-08 and 2008-09;
- acquisition and deferred acquisition costs remain constant;
- ARPC expenses to increase by 5 per cent each year for 2007-08 and 2008-09;
- investment income calculated on the average cash and investment balances noted in the balance sheet for 2007-08 and 2008-09; and
- interest rate is the current cash rate of 5.75 per cent.

the scheme will, all other things being equal, maintain or increase the probability that the scheme would cover the full value of losses if a terrorist incident was to occur.

By continuing to charge premiums, the ARPC will also ensure that new insurers and policyholders that access the scheme are not given a 'free ride' at the expense of existing insurers and policyholders.

Option 3 — In addition to option 2, increase risks assumed by the commercial insurance market

Option 3 impact summary		
Stakeholder	**Costs**	**Benefits**
Policyholders	Excesses or premiums may rise to reflect the additional risk retained by insurers.	Nil
Insurance industry	124 insurers would each retain a minimum of $100,000 of terrorism risk. These 124 insurers would collectively retain an additional $6,892,628 of terrorism risk.[47] 34 insurers would each retain between $1m and $10m of terrorism risks (a maximum increase of $9m per insurer). The insurance industry would retain $100m of terrorism risks for any one incident. This is an additional $90m of terrorism risks.	Nil
ARPC	Nil	Assumes less risk for the same premium. The risk reduction matches the cost increase for insurers.
Australian Government	Nil	In the event of a terrorist incident, the likelihood of Commonwealth contribution decreases as the value of the pool increases and insurer retentions increase.

47 The ARPC has advised that 124 insurers in the scheme currently retain less then $100,000 of terrorism risks. In total, these 124 insurers currently retain $5,507,371.72 of terrorism risks. Increasing the minimum retention to $100,000 would require these 124 insurers to retain, in total, $12,400,000 of terrorism risks. This is an increase of $6,892,628.28.

Costs

Retentions

Insurers would be required to assume more risk under the scheme.

There are currently 124 insurers for whom 4 per cent of fire and ISR premium collected in Australia is equal to or less than $100,000. In total, these 124 insurers currently retain $5,507,372 of terrorism risks.[48]

Under option 3, each of these insurers would be required to retain $100,000 of terrorism risks. That is, these 124 insurers would have to retain $12,400,000 of terrorism risks in total. This is an increase of $6,892,628.[49]

Alternatively, such insurers might decide to cease reinsuring with the scheme and cover the terrorism risks themselves.

Currently, there are 34 insurers for whom 4 per cent of fire and ISR premiums collected is equal to or greater then $1 million. Hence, these insurers currently retain $34 million of terrorism risks in total.[50] Under option 3, these insurers would be required to retain additional risk, first up to a maximum of $5 million and then up to a maximum of $10 million. How much the retention levels for each of these 34 insurers increases will depend on whether 4 per cent of fire and ISR premiums collected is less than or greater than $5 million and then $10 million, respectively.

Insurers for whom 4 per cent of fire and ISR premiums collected is greater then $100,000 but less then $1 million would be unaffected by the increase in retention levels under option 3. This is currently 62 insurers.[51]

The insurance industry would be required to retain more risk for any one incident, first up to $25 million, then $50 million and then up to $100 million. In total, this will be an increase of $90 million in retentions for the insurance industry.

Insurers would also face compliance costs in educating themselves about the raised retentions, assessing the impact on their premiums, capital requirements and reinsurance arrangements and making any necessary changes to systems and regular reports (such as annual financial accounts). Insurers would need to reconsider the impact of increased retentions each time an increase occurred that affected them. Therefore, as 124 insurers would be required to meet the

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48 ARPC advice as at 29 May 2006.
49 Ibid.
50 Ibid.
51 Ibid.

minimum retention after the first change, those 124 insurers would only need to consider the issue once and would have average costs of $45,000 each. In contrast, the 96 insurers that exceed the minimum retention would have to consider the issue three times and would have average costs of $135,000 each over three years. The total compliance cost for all affected insurers would be likely to be in excess of $18.54 million over three years.[52]

Whether or not an increase in retentions would have an effect on the capital requirements for insurers depends on the size of the insurer and the size of the retentions the insurer holds for other risks.

Whether or not an increase in insurer retentions would also have an effect on the premiums charged to policyholders is also dependent on a range of factors. Most simplistically, consider an example where a policyholder pays $1100 for $10 million in cover and the insurer has a $5 million retention on its reinsurance. In this case, the insurer charges the policyholder $200 per million retained plus $20 per million reinsured. If, however, the insurer's retention on the reinsurance is raised to $6 million, the insurer may charge the policyholder $1280 for $10 million in cover, that is, $200 per million retained plus $20 per million reinsured.

Despite these possible effects, the Australian Prudential Regulation Authority has advised that, broadly, it would expect that the majority of the industry would experience no increase in capital requirements for changes of the nature proposed in option 3.

The majority of insurers choose to have retentions for commercial reinsurance that are equal to or larger than retentions proposed under option 3. As such, the majority of insurers already hold sufficient capital to cover the retention increases proposed under this option.

Other things being equal, increasing retentions under the scheme will make commercial insurance more competitive. There is the potential that, as commercial insurance becomes more competitive, the risk of adverse selection for the scheme will increase. That is, there is a risk that the ARPC will increasingly be left with only higher risk policies that commercial reinsurers refuse to cover.

52 Compliance costs for insurers are calculated on the following assumptions. All 124 insurers that hit the $100,000 minimum retention in the first year continue to reinsure with ARPC and spend an average of $45,000 on these tasks (30 hours x $1,500 per hour labour costs for actuarial, accounting, legal, systems and administrative services). All remaining 96 insurers continue to reinsure with the ARPC and spend an average of $135,000 on these tasks over three years (90 hours x $1,500 per hour labour costs for actuarial, accounting, legal, systems and administrative services).

However, as outlined earlier, while the market for terrorism insurance has recovered somewhat since the scheme was introduced, insufficient terrorism insurance is currently available commercially on reasonable terms. As such, this potential cost is not an issue currently, but should be borne in mind as commercial terrorism insurance capacity increases in the future.

Benefits

Retentions

Current retention levels under the scheme are low compared to reinsurance industry standards.

Introducing a minimum retention level would require insurers to assume more risk. Some of these insurers may determine they can afford to cover all terrorism risks relating to their commercial insurance policies and cease reinsuring with the scheme.

Raising the maximum insurer retention levels would make reinsurance offered by the scheme more comparable to reinsurance arrangements offered commercially. Higher retention levels would require commercial insurers to assume more terrorism risks. Alternatively, insurers could seek a small amount of commercial reinsurance to cover their retention levels.

All of these changes require or encourage greater involvement of the commercial market in covering terrorism risks. It also means that some risk is transferred from the ARPC and the Commonwealth (and ultimately Australian taxpayers) back to the commercial insurance market.

Comparable schemes overseas have also raised retention levels to encourage greater involvement of the commercial market. Between 2003 and 2005, the United States of America raised insurer and industry retention levels under Terrorism Risk Insurance Act. In 2003, insurer retentions were set at 7 per cent of an insurer's direct earned premium over the previous year. The government increased these in 2004 to 10 per cent and to 15 per cent in 2005. In 2003, industry wide maximum retention amounts were set at $10 billion. They were raised to $12.5 billion in 2004 and $15 billion in 2005.[53]

The United Kingdom also raised industry retentions under Pool Re. In 2003, industry wide retentions were set at £30 million per event and £60 million per year. These retentions were increased to £50 million and £100 million in 2004,

53 OECD, above, n 5, 95-6, 263.

£75 million and £150 million in 2005 and £100 million and £200 million in 2006.[54]

Along similar lines, from 2002 to 2004, France raised the amount that must be covered by commercial insurers and reinsurers before the state guarantee applies under GAREAT.

Raising retentions under the Australian scheme is consistent with the actions of terrorism insurance schemes in other countries. A principle of the scheme was that it should be consistent with global solutions.

Option 3 would phase retention increases in over three years. The ARPC and the Australian Prudential Regulation Authority have indicated that this time would assist industry to adjust to the new requirements.

Implementation costs for insurers under option 3 would be minimal. Any costs would relate to recalculating capital requirements, which could be undertaken as part of an insurer's regular actuarial review.

Option 4 — In addition to option 3, only charge premium on risks excluded under a bundled policy

Option 4 impact summary		
Stakeholder	**Costs**	**Benefits**
Policyholders	Nil	May pay less premium on bundled insurance policies.
Insurance industry	Nil	Insurers would pay less premium to the ARPC on bundled policies.
ARPC	Would lose an amount of premium on bundled policies.	Nil
Australian Government	Nil	Nil

Costs

Premiums on bundled insurance products

The ARPC would receive less reinsurance premium on bundled insurance products that did not exclude all terrorism risks. However, this would more closely correlate with the risk that the ARPC assumed.

The ARPC's additional administration costs under this option would be negligible. In calculating the applicable reinsurance premium, the ARPC relies

54 Ibid, 96, 259.

on the insurer advising of the underlying premium. The ARPC is able to verify the accuracy of the information provided by the insurer because its reinsurance agreement gives it the right to inspect and take copies of relevant documents held by the insurer.

Insurers would also face 'start-up' costs in educating themselves about this change, assessing its impact on their policyholders and reinsurance arrangements and making any necessary changes to systems and regular reports (such as annual financial accounts). The total 'start-up' cost for all affected insurers would be likely to be in excess of $1.65 million with an average cost per insurer of $15,000.[55]

Benefits

Premiums on bundled insurance products

Option 4 would involve changes to the way reinsurance premiums are calculated on bundled insurance products to ensure that the ARPC receives premiums that more appropriately reflect the risk it assumes.

A bundled policy that excludes all terrorism risks would be charged more for reinsurance than a similar bundled policy that covers some terrorism risks.

If an insurer believed they could offer some terrorism risk cover at a lower cost than the ARPC, option 3 would provide no impediment to providing such competitive cover through a section of a bundled insurance policy.

This also means that a commercial insurance policyholder would not effectively be charged twice for cover for some terrorism risks. If an insurer provided cover under a section of a bundled insurance policy, the policyholder would only pay the insurer for that cover.

Option 4 would encourage insurers to provide some cover for terrorism risks in bundled insurance policies. This would encourage greater involvement of the commercial insurance market.

55 'Start-up' costs for insurers are calculated on the assumption that none of the approximately 110 foreign or captive insurers reinsuring with the ARPC (and who provide only approximately 5 per cent of reinsurance revenue) have bundled policies. However, it is assumed that all of the remaining 110 insurers have bundled policies and with each spending an average of $15,000 on these tasks (10 hours x $1,500 per hour labour costs for actuarial, accounting, legal, systems and administrative services).

CONCLUSION

A key principle underpinning the terrorism insurance scheme is that it should encourage, to the greatest extent possible, private sector provision of insurance. Another principle is that any risk transferred to the Commonwealth should be appropriately priced and that the Commonwealth should be compensated by those benefiting from the scheme. If the ARPC offered reinsurance for no charge, it would reduce private sector provision of terrorism risk cover and competition with the scheme, risk transferred to the Commonwealth would not be appropriately priced and those benefiting from the scheme would not be compensating the Commonwealth. As a result, the costs of option 1 to the community as a whole outweigh its benefits.

Option 2 would maintain the current level of commercial market involvement. The benefits of option 2 outweigh its costs to the community as a whole.

Option 3 would increase the risk retained by the insurance market. It would move the scheme closer to a position comparable to the commercial market and thus encourage greater market involvement. Raising retentions is also consistent with the actions of comparable schemes overseas. The benefits of option 2 to the community as a whole outweigh its costs.

Option 4 incorporates the changes in options 2 and 3 as well as allowing the ARPC to reduce the premium it charges on bundled insurance policies that insure some terrorism risks. This will remove a disincentive for insurers to cover additional terrorism risks. The benefits to the community as a whole of option 4 outweigh its costs. As option 4 incorporates all of the benefits in options 2 and 3 it is the superior choice.

RECOMMENDATION

It is recommended that option 4 is implemented, which involves:

- requiring the ARPC to continue charging premiums for reinsurance at current levels, subject to further review in no more than three years;
- once the pool reaches $300 million, the ARPC using its discretion to determine whether to use premiums to build the pool further, purchase reinsurance for the scheme or undertake a combination of the two;
- increasing retention levels in three increments (with effect, respectively, from 1 July 2007, 1 July 2008 and 1 July 2009) as outlined in the table below:

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

- in relation to bundled insurance policies, the ARPC being required to charge reinsurance premiums only on those sections of the policy to which terrorism exclusions apply.

CONSULTATION

TIMING AND APPROACH TO CONSULTATION

In the first half of 2006, the Treasury conducted the first review of the need for the *Terrorism Insurance Act 2003* (the Act) to continue in operation, as required by section 41 of the Act.

The Treasury consulted directly with key stakeholders. This involved writing to representatives of insureds, brokers, banks, insurers and reinsurers. Several stakeholders responded by either providing a submission or by meeting with officers from the Treasury. The Treasury also consulted relevant Government officials. The Appendix list all stakeholders that either provided a submission or otherwise communicated with the Treasury in the course of the review.

VIEWS OF THOSE CONSULTED

The broad views of key stakeholders are provided below.

Need for the Terrorism Insurance Act

As noted above, the Insurance Council of Australia, the Property Council of Australia and the Australian Bankers' Association and the Australian Reinsurance Pool Corporation (ARPC) all considered there was insufficient terrorism insurance currently available on reasonable terms and there is a need for the Act to continue in operation.

Refining the scope of the scheme

The Water Services Association of Australia (via the Attorney-General's Department), the Property Council of Australia and the ARPC supported the extension of the terrorism insurance scheme to include commercial insurance provided to local government utilities, such as local or regional water authorities.

The Insurance Council of Australia, the Property Council of Australia and the Australian Bankers' Association supported the inclusion of commercial insurance for high-rise residential property in the scheme.

Charles Taylor Consulting, which manages two large discretionary mutual funds (DMFs), supported extending the terrorism insurance scheme to DMF products. In contrast, the Insurance Council of Australia and the Property Council of Australia opposed extending the scheme to DMF products.

Encouraging commercial involvement

The ARPC supported the continued collection of reinsurance premiums at the current rate. The Property Council of Australia considered that the ARPC should cease collecting reinsurance premiums after the ARPC's pool has reached the initial target of $300 million. Alternatively, the Property Council of Australia considered the continued collection of reinsurance premiums acceptable until the ARPC's pool reached $500 million, so long as reinsurance premiums are reduced once the ARPC's pool reached $300 million.

The ARPC and the Property Council of Australia supported the raising of insurer risk retention levels. The Insurance Council of Australia considered that there was insufficient time for industry to assess this proposal and thus the scheme should be carried forward on its existing basis.

The Insurance Council of Australia and the Property Council of Australia supported changing the reinsurance premium charged for bundled insurance policies so that a premium was charged only on those portions of the policy that exclude terrorism risks.

Implementation and Review

Implementation

Method

The recommended extension of the terrorism insurance scheme to include commercial insurance provided to public authorities is to be implemented by amending the *Terrorism Insurance Regulations 2003* (the Regulations).

The recommendation that the Australian Reinsurance Pool Corporation (ARPC) be required to continue collecting premiums at the current rate requires no implementation. Also, no implementation is required to empower the ARPC to purchase reinsurance for the terrorism insurance scheme.

The recommendation that insurer risk retentions be raised is to be implemented by amending the *Treasurer to Australian Reinsurance Pool Corporation (Risk Retention) Direction 2003*. Relevant changes are also to be made to the standard form reinsurance agreement between the ARPC and each insurer.

The recommendation that there be a change to the reinsurance premium charged by the ARPC on bundled insurance policies is to be implemented by amending the *Treasurer to Australian Reinsurance Pool Corporation (Premiums) Direction 2003*. Relevant changes are also to be made to the standard form reinsurance agreement between the ARPC and each insurer.

Timing

Changes to the Regulations will commence on 1 July 2007. A transitional clause will mean that each commercial insurance contract for a public authority will be included in the scheme at the time, on or after 1 July 2007, that the contract commences or is renewed.

Changes to the standard form reinsurance agreement between the ARPC and each insurer—made as a result of amendment to the *Treasurer to Australian Reinsurance Pool Corporation (Risk Retention) Direction 2003* or the *Treasurer to Australian Reinsurance Pool Corporation (Premiums) Direction 2003*—will take

effect either on the dates specified in the direction or no sooner than three months after the insurer receives written notice from the ARPC (consistent with the existing terms of the reinsurance agreement).

Consultation

The Regulations, the *Treasurer to Australian Reinsurance Pool Corporation (Risk Retention) Direction 2003* and the *Treasurer to Australian Reinsurance Pool Corporation (Premiums) Direction 2003* are all legislative instruments for the purposes of the *Legislative Instruments Act 2003*.

The Treasury consulted on amendments to these legislative instruments, consistent with the requirements in section 17 of the *Legislative Instruments Act 2003*. Specifically, the Treasury made exposure drafts of these legislative instruments publicly available on its website on 8 December 2006 and invited public comment by 15 January 2007. The Treasury also provided the exposure drafts directly to key stakeholders.

Review

As noted above, section 41 of the *Terrorism Insurance Act 2003* (the Act) requires the Treasurer to produce a report that reviews the need for the Act to continue in operation at least every three years. The next review would provide an opportunity for the impact that the Act has on business to be considered again.

In addition, section 50 of the *Legislative Instruments Act 2003* will automatically repeal the Regulations on their tenth anniversery. This 'sunsetting' provides an opportunity for the Regulations to be reviewed.

Note, however, that neither the *Treasurer to Australian Reinsurance Pool Corporation (Risk Retention) Direction 2003* or the *Treasurer to Australian Reinsurance Pool Corporation (Premiums) Direction 2003* are subject to the 'sunsetting' provisions in the *Legislative Instruments Act 2003* (see item 46 in the table in subsection 54(2)).

APPENDIX

CONSULTATION WITH STAKEHOLDERS

The Treasury consulted the following stakeholders:

- American Insurance Group;
- Aon Re Australia Ltd;
- Australian Prudential Regulation Authority;
- Australian Reinsurance Pool Corporation;
- Attorney-General's Department;
- Australian Bankers' Association;
- Benfield (Australia) Limited;
- Charles Taylor Consulting (Australia) Pty Ltd;
- Insurance Council of Australia;
- Lloyd's Australia Limited;
- National Insurance Brokers Association of Australia;
- Property Council of Australia; and
- Swiss Re (Australia) Limited.