PART III B

Chapter 18

The Spanish Experience in the Management of Extraordinary Risks, Including Terrorism

by
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In December 1954, the 'Consorcio' became the masterpiece in one of the oldest State backed systems dealing with Extraordinary Risk Cover, terms that in this system include perils of nature (flood, earthquake, volcanic eruption, storms) and socio-political risks, essentially terrorism. This chapter provides an overview of the Consorcio and its main reforms.

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1. Short sight to history: the origins

The objective of this note is to put forward what the 'Consorcio de Compensación de Seguros' has represented in the past and what it represents nowadays in Spain. It has been, from a historical overview, a successful experience, with a high projection to the future.

In this perspective, this year is the commemoration of the fiftieth anniversary of the Law that gave permanent regulation to the 'Consorcio' in its shape as a stable mechanism for the compensation of damages from extraordinary events, after a provisional period which begun in 1941, constituting the remote background of the 'Consorcio'.

Actually, that year 1941, counting on State and private market participation, an instrument allowing to face the compensation of the enormous damage produced on people and goods along the Civil War (1936-1939) was established, as those damages were far above the low capacity of the insurance undertakings of the period. An instrument that was later used to compensate for several big losses, not related to the war, produced at that time: 1941: Santander fire; 1944: Canfranc and Ferrol fires; 1947: mines explosion in Marina, Cádiz; and 1948: gunpowder arsenal explosion in Alcalá de Henares.

It was just the good results raised along that provisional period, that induced to give permanent status and continuity to the 'Consorcio' in order to be able to face up in the future risks with a large loss potential, as the Extraordinary Risks, that private market was unable to assume.

2. Stabilisation and development: adaptation capacity

That definite step took place in December 1954. The 'Consorcio' became the masterpiece in one of the oldest State backed systems dealing with Extraordinary Risk Cover, terms that in this system include perils of nature (flood, earthquake, volcanic eruption, storms) and socio-political risks, essentially terrorism. With respect to the latter, Spanish insurance industry has paid special attention to it through this institution as, unfortunately, terrorism is not a new subject in Spain.

One of the keys for the survival and good health of the 'Consorcio' is its flexibility, its capacity to adapt to the requirements of the insurance sector at every time. It constitutes a dynamic instrument, that has not focused just the cover of extraordinary risks, but also, and with an essentially subsidiary nature, it has received new tasks in other lines of insurance, following

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market needs; lines such as Export Credit Insurance, Compulsory Travellers Insurance, Hunting Compulsory Insurance, Motor Car Third Party Liability Insurance, Multiperil Crop Insurance, etc.; as well as different non-insurance activities as the winding-up of insurance undertakings, the management of the so-called FIVA (Insured Vehicles File), prevention, etc. This is the origin of the character and vocation of the 'Consorcio' as an instrument at the service of Spanish insurance industry, acting always in full collaboration with the sector.

As a result of those developments, the legal nature of the 'Consorcio' has also been modified for a better adaptation to the new circumstances. After 1954, certainly the most important modification took place in December 1991, as a result of the adaptation requirements to Community regulations, following Spain accession to the European Community, in 1986. As a result of that the 'Consorcio', apart from losing the monopoly that it had from the start in the cover of Extraordinary Risks, stopped being a State institution and became a public business institution, attached to the Ministry of Economy and Finance. An institution with its own legal personality and full capacity to act, its own assets independent from the State's, and whose activity is subject, as any other insurance undertaking, to laws ruling private companies.

From that time, the 'Consorcio' is managed by an Administration Board, chaired by the Director General of Insurance and Pension Funds and with a mixed composition, including equal numbers of representatives from State Administration and from private insurance market, all of them appointed by the Minister of Economy and Finance. This Board applies the same management criteria as any private company, therefore looking for maximum efficiency. In particular, claims are dealt with by a decentralised management through 18 regional offices.

A last feature worth mentioning is that the 'Consorcio' employs 365 people and counts on some 350 external professionals, particularly adjusters and lawyers.

3. Natural disasters and terrorism: reaction capacity

In the last two decades, from an international perspective, natural disaster losses have substantively increased, and we can observe a tendency towards higher losses as a result of a higher vulnerability provoked by factors essentially anthropic in origin: higher concentration of people and values in risk areas; higher value of goods insured; lack or deficiency in mitigation and prevention policies; increase of catastrophic climatic events as a result of global warming.

This loss behaviour has caused serious troubles to the insurance and reinsurance markets, and has given way to various approaches on the suitability, relevance, need and even demand of public intervention in order to provide an insurance cover economically and socially sustainable. On top of that, and in a period of time much shorter than the catastrophic dynamics concerning natural events, terrorism is not any more an irrelevant risk, has become very difficult to delimit, and insurance and reinsurance markets are not always able to assume it. September 11 attacks marked a sudden change, without any transition, and March 11 attacks in Madrid have tragically deepened this wound. Of course, the effects of September 11, so negative on international insurance and reinsurance markets, finally affected a part of Spanish insurance supply, and were felt in the 'Consorcio', essentially in aviation and business interruption related to the risk of terrorism.

In the first case, the hard cut in cover for non-passenger third party liability concerning the risk of terrorism and war led Spanish Government to ask to the 'Consorcio', for a transition period and in the framework of the decisions taken within the ECOFIN, to cover that risk on behalf of the State. Our institution fulfilled those tasks up to October the 31st 2002, when there was a chance to find that cover in the market. Regarding business interruption related to terrorist acts, it is worth pointing out that the Association of Insurance Undertakings, UNESPA, signed up an agreement with the 'Consorcio' by which our institution covered, as reinsurer, companies freely joining the agreement. This agreement has been in force until the moment that business interruption has been actually integrated in extraordinary risks cover system (previously only direct damage was covered). That means that now it is a direct cover, not reinsurance, and that the 'Consorcio' assumes it not just for terrorist acts but for any natural or socio-political event included in the system.

Until recently only extraordinary losses consequence of events taking place in Spain were covered. Certainly we can also attribute to the tragic legacy of September 11 the inclusion in Extraordinary Risks cover of damage to people (covered by accident policies) for events being included in the system, happening abroad, and provided that the policyholder has his residence in Spain. Obviously the afterthought was mainly events of terrorism.

The March 11 attacks, a human disaster that, with 192 deaths and about 1,500 wounded, have left in the conscience of Spanish people an ineffaceable track of pain, as well as the pride of a model civic reaction. For insurance, however, the scope of damages and compensations that the 'Consorcio' had to face, was more limited than expected. Claims were mainly on personal damage (branch of accidents), since the goods having suffered the highest material damage, i.e. the wagons, were not insured.

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The 'Consorcio' has focused specially and as a priority in the personalised attention to those harmed in this terrorist event, trying to reduce to the essential minimum the period of procedure for the claims.

Related to this attack, more than 1000 files of claim for compensation, 952 for personal damage (192 for death) and 58 for material damage, have been opened. Half this number has already been terminated, for a total amount of compensations slightly above EUR 20 million. 442 files are not yet terminated, essentially because for many injured people sequels have not yet been definitely established. For those files a provision of funds for an amount of EUR 15 million has been constituted. Therefore, and according to those data, we can expect that compensations for damages produced by the attack will represent for the 'Consorcio' payments for an amount close to EUR 35 million.

4. Characteristics of the cover system for extraordinary risks

4.1. Wide-sense Compensation.

The system is based on the principles of solidarity, compensation, cooperation and subsidiarity.

- Solidarity among the insured through mutualisation.
- Temporary compensation, between accounting years.
- Territorial compensation, among different geographic areas.
- Compensation of risks, among the different hazards covered.
- Cooperation between the private market and a public institution as the 'Consorcio'.
- Subsidiarity, as the 'Consorcio' behaves only when and where the market does not assume the cover.

4.2. Compulsory character

Extraordinary risks cover must be compulsorily included in the policies of certain lines of damage on goods (fire and natural events, land vehicles, other damage to goods, business interruption, and so on) and in personal accident policies, even though underwriting of those policies is, however, free. The compulsory character guarantees the possibility of the abovementioned mutualisation and allows to provide a feasible, and no burdensome, solution to the problem of adverse selection. This is a cover compulsorily joined to a master policy, to be underwritten by private insurance undertakings, and in no case by the 'Consorcio de Compensación de Seguros'. This procedure obviously benefits the promotion of insurance in lines where the inclusion of extraordinary risks cover is compulsory.

4.3. Subsidiarity and guarantee fund

If the underwriting company does not cover explicitly those risks, they are covered by the 'Consorcio'. It would contact the insured just in case of loss, respecting capitals insured and conditions of compensation established in the ordinary policy. Therefore, the company deals with the policy and the 'Consorcio' deals with loss and compensation. It would also assume compensation in the event that the underwriting company covering the extraordinary risk were unable to assume its commitments, due to bankruptcy or to winding-up by the 'Consorcio'. Thus the 'Consorcio' acts as guarantee fund.

4.4. Price of the cover: the surcharge

The price of the cover is a **surcharge** that, with different rates according to the kind of good covered, is applied compulsorily on the capital insured in the policy, and is collected, together with the corresponding premium, by the company, which credit it monthly to the 'Consorcio'. The companies deduct a collection charge for this service.

4.5. Risks and damage covered by the system

Risks covered by the system are:

- **Perils of nature**: flood (direct rain and overflow of artificial channels is excluded), volcanic eruption, earthquake, seaquake, sea-breaking on land, fall of meteorites, and storms (it includes, among other, tornadoes and gusts of wind above 135 km/h.).
- **Socio-political events**: terrorism, riot, rebellion, civil commotion and sedition, as well as acts of law enforcers (Army, Police) during peacetime.

Up to recent times only direct damage on people and goods, including mud extraction, demolition and debris removal expenditure, for losses taking place in Spain affecting risks located in the country were covered. Recently, as already said, business interruption as result from direct damage was included, as well as damage to people suffered abroad due to extraordinary events when the policyholder is a resident in Spain.

4.6. Qualitative cover

As a characteristic it must be emphasised that it is a qualitative and not a quantitative cover, as the reference is neither a minimum accumulation of loss nor a minimum geographical extension and of affected people that ought to be reached, but the damage potential of an extraordinary event, independently from the actual scope of the latter in a particular loss. That means that compensation does not depend on the amount of losses, on its geographical extension, on the number of affected insured people nor on the official declaration as disaster area, but on affected people (it might be only one) having a policy of the lines mentioned covering damaged goods, having paid the corresponding surcharge and on the cause of loss being under the legal definition of any of the events included in the system. It is a way of guaranteeing legal safety of people suffering losses and of making claim proceedings and the management of compensation independent from politics, as they do not depend neither on the valuation nor on the decision of any authority that had previously to pronounce itself about the character of the loss.

4.7. Resources and equalisation reserve

Resources of the ‘Consorcio’ to face its corresponding losses come essentially from surcharges abovementioned. As a financial safety mechanism, and besides the provisions and margins of solvency required to any insurance company, the ‘Consorcio’ has an Equalisation Reserve, that counts on a soft tax treatment and whose resources come from each financial year profits. This provision acts as a special and big fund for losses allowing compensation between years with high and with low loss-ratio. At this moment it has reached the amount of EUR 2,425 million.

Apart from that, the ‘Consorcio’ benefits from the guarantee of the State. Nevertheless, up to the present it has never needed it to pay compensations, despite the fact that it has faced important losses in the past.

5. Loss data

Total amount of compensations paid by the ‘Consorcio’ between 1987 and 2003, as a result of damage on goods for extraordinary events is EUR 1,631 million, 85.0 per 100 corresponding to flooding losses, 8.9 per 100 to damage for terrorism, 2.6 per 100 to civil commotion, and 2.5 per 100 to atypical cyclonic storm.

For the period 1971-2003, and also with regard to damage on goods, income for surcharges reached a total of EUR 6,139 million (updated).

Compensations reached a total amount of EUR 4,171 million (updated), which represents a loss-ratio of 67.95 per 100. It means that, in accordance with the erratic behaviour of the type of risks concerned, with respect to frequency and intensity, besides reduced or moderated losses for years, there appear some picks of losses increasing that loss-ratio to the following levels: 655.27 in 1983; 283.01 in 1982; or 240.89 in 1987.

The distribution of Consorcio's payments per type of goods affected during the period 1987-2003 is the following: 34.81 per 100 of the compensations correspond to "Business and other simple risks"; 30.99 per 100 to "Industrial risks"; 22.57 per 100 to "Housing and offices"; 7.46 per 100 to "Motor vehicles"; and 4.17 per 100 to "Civil works".

In the section damage to people, for the period abovementioned (1987 to 2003), compensations paid by the 'Consorcio' reached a total of EUR 21 million. From this amount, 87 per 100 corresponded to events of terrorism and 12 per 100 to flood.

Table 18.1 Extraordinary risks - Property and personal accidents Total payments distribution per causes (in Euros) – Period 1987-2003

Cause	Property	%	Personal Accidents	%
Flood	**1,385,383,648**	**85.0**	**2,496,211**	**11.9**
Earthquake	16,725,642	1.0	0	0.0
Atypical cyclonic storm	40,235,666	2.5	0	0.0
Falling astral bodies and meteorites	41,470	0.0	0	0.0
Terrorism	**144,837,337**	**8.9**	**18,328,196**	**87.1**
Riots	681,768	0.0	0	0.0
Civil commotion	41,633,661	2.6	90,812	0.4
Acts of the Armed Forces	1,161,258	0.1	125,611	0.6
TOTAL	**1,630,700,450**	**100**	**21,040,830**	**100**

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Table 18.2 Extraordinary risks - Property
Total payments distribution per type of risk (in Euros) - Period 1987-2003

Type of risk	Property	%
Housing and Offices	367,986,707	22.6
Businesses and shopping centres	567,677,1412	34.8
Industrial risks	505,395,386	31.0
Civil works	68,040,203	4.2
Motor Vehicles	121,601,013	7.5
TOTAL	**1,630,700,450**	**100**

Table 18.3 Extraordinary risks - Property
Premiums and total payments distribution (in Euros) - Period 1971-2003

Years	Premiums updated	Total payments updated	Loss ratio (%)
1971-1980	895,179,115	741,813,652	82.87
1981-1990	1,337,527,336	1,944,085,583	145.35
1991-2000	2,737,361,338	1,101,063,120	40.22
2001	373,373,688	165,617,611	44.36
2002	379,226,400	132,694,030	34.99
2003	416,043,733	86,041,073	20.68
TOTAL	**6,138,711,609**	**4,171,315,069**	**67.95**

Table 18.4 Extraordinary risks - Property
Premiums and total payments distribution (in Euros) – Years with special payments

Years	Premiums updated	Total payments updated	Loss ratio (%)
1982	114,143,112	323,039,657	283.01
1983	114,061,407	747,407,907	655.27
1987	121,779,438	293,356,125	240.89
1989	183,603,203	238,493,284	129.90

Table 18.5

EXTRAORDINARY RISKS – PROPERTY PREMIUMS AND TOTAL PAYMENTS DISTRIBUTION

YEARS	PREMIUMS UPDATED	TOTAL PAYMENTS UPDATED	LOSS RATIO (%)
1971	69,108,093	461,147,951	667.29
1972	72,459,076	18,351,200	25.33
1973	79,337,912	2,250,331	2.84
1974	83,931,339	435,979	0.52
1975	92,878,803	2,622,690	2.82
1976	95,686,062	16,668,884	17.42
1977	96,012,889	91,837,675	95.65
1978	95,552,364	41,057,518	42.97
1979	102,922,321	34,248,933	33.28
1980	107,290,256	73,192,492	68.22
1981	108,409,056	50,573,172	46.65
1982	114,143,112	323,039,657	283.01
1983	114,061,407	747,407,907	655.27
1984	116,650,445	59,818,853	51.28
1985	124,185,624	30,396,892	24.48
1986	128,226,575	71,177,143	55.51
1987	121,779,438	293,356,125	240.89
1988	128,036,019	90,020,319	70.31
1989	183,603,203	238,493,284	129.90
1990	198,432,457	39,802,231	20.06
1991	213,637,986	52,533,624	24.59
1992	228,223,075	69,764,543	30.57
1993	238,841,990	39,649,416	16.60
1994	245,913,175	96,101,626	39.08
1995	255,121,194	104,191,273	40.84
1996	267,150,107	136,256,684	51.00
1997	291,963,732	261,126,147	89.44
1998	309,306,666	52,380,387	16.93
1999	329,993,202	114,920,346	34.83
2000	357,210,210	174,139,073	48.75
2001	373,373,688	165,617,611	44.36
2002	379,226,400	132,694,030	34.99
2003	416,043,733	86,041,073	20.68
TOTAL	**6,138,711,609**	**4,171,315,069**	**67.95**

EUROS

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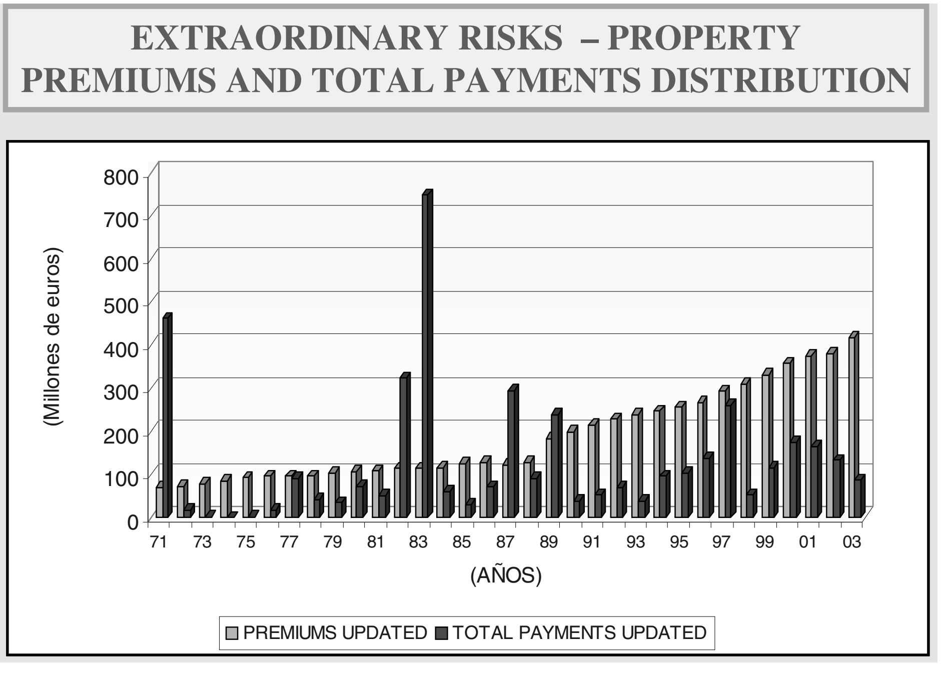
Figure 18.1



6. Challenges of the future.

The whole accumulated experience and the mechanisms and processes enabled to assume the insurance treatment of natural disasters and risks like terrorism place the 'Consorcio' in a favourable initial position to face challenges of the future, which will demand adjustment efforts and imaginative solutions in co-operation with the market. At least two of those challenges will have an uncertain, but surely impressive, development: climate change and mega-terrorism.

Even from a non pessimistic point of view, one must admit that global warming might provoke an increase in extreme climatic events, as much in frequency as in intensity. Although insurance industry has not the exclusivity in the search for preventive solutions, which will be essential, it will have to offer insurance alternatives according to each climatic reality. Certainly, a field of close collaboration will have to be opened among the insurance industry, the public authorities and the insured themselves.

With respect to mega-terrorism, the variety of possible aims eventually threatened and the full range of methods usable in the attacks offer, for the near future, an uncertain perspective with respect to the scope of the risk to be faced. But when considering chemical, biological, nuclear and even informatics attacks, with large geographical areas potentially affected and their corresponding damage on lives and goods, the risk to be faced is almost similar to a war and, therefore, non-insurable.

Far from alarmist predictions, the 'Consorcio' will celebrate this year 2004 its fiftieth birthday with the satisfaction of having developed, with proved effectiveness, a task of service to insurance industry and to Spanish society as a whole, and so hopes to do in the future.

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Annex 1

List of Speakers and Presentations at the Conference*

Session 1 - Insurability of catastrophic risks

- Economics of catastrophe risk insurance, *Christian Gollier (University of Toulouse).*
- Insurability of terrorism risk: challenges and perspectives, *Howard Kunreuther and Erwann Michel-Kerjan (Wharton School, University of Pennsylvania).*
- Industrial, technological and other catastrophes, *Christian Lahnstein (Munich Re).*
- Recent trends in the catastrophe risk insurance/reinsurance market, *Patrick Murphy O'Connor (Benfield).*
- Role of the reinsurance industry in the management of weather related risks, *Peter Zimmerli (Swiss Re).*
- Issues and options in the management of terrorism risk through insurance, *Robert Reville (Rand Corporation).*
- Current state of the coverage for war and terrorism risks - including NBC - in the aviation sector, *Eugene Hoeven (IATA)*
- Free market solutions for terrorism risks coverage, *Ben Garston (MAP Underwriting and Lloyd's Terrorism Panel).*

* Power point presentations summarising papers included in this publication as well as other presentations made at the conference are available on the OECD Insurance homepage: http://www.oecd.org/daf/insurance.

- Improving insurability and affordability: the role of insurance in hazard identification, risk assessment, risk prevention and mitigation for industrial/chemical accidents, *Satyananda Mishra, IAS, Disaster Management Institute, Bhopal - Government of Madhya Pradesh, India).*

Session 2 - Financial market solutions to manage catastrophic risks

- International financing solutions to catastrophic risk exposures, *Torben Juul Andersen (Copenhagen Business School).*
- The use of risk linked securities to manage catastrophic risks, including terrorism, *Christian Mumenthaler (Swiss Re).*
- Current challenges in terrorism risk securitization, *Gordon Woo (RMS).*
- Financing catastrophic risks in non-OECD countries: challenges and perspectives*, Reinhard Mechler (IIASA).*
- Current market trends for catastrophe bonds and risk kinked securities, *Christopher McGhee (MMC Securities, Guy Carpenter).*
- The potential for new risk transfer instruments to cover terrorism risks, *Michele David (The Bond Market Association).*
- Rating agency's perspective on catastrophe bonds and risk linked securities, *Rodrigo Araya (Moody's).*

Session 3 - Role of governments and development of public-private partnerships for catastrophe risk management

- Role of governments in natural catastrophe risk management and financing in OECD countries, *Paul K. Freeman (University of Denver).*
- Catastrophe insurance programs in emerging countries: field experience, *Eugene Gurenko (World Bank, Financial Sector Operations and Policy Department).*
- Potential role for governments in terrorism coverage, *Dwight Jaffee (Haas School of Business, UC Berkeley).*
- Public-private partnerships to cover terrorism risks in OECD countries, *John Cooke (International Economic Relations Consultant, London).*

- Role of the US government in the prevention and mitigation of terrorism risks, *Robert Liscouski (Infrastructure Protection Office, Department of Homeland Security, USA).*
- Disaster risk management policy in Japan, *Kazuhiro Kawachimaru (NIPPONKOA Insurance Company Ltd).*
- The Spanish experience in the management of extraordinary risks, including terrorism, *Ignacio Machetti (Consorcio de Compensación de Seguros).*
- A stakeholder approach for developing a public-private partnership: the Hungarian case*, Reinhard Mechler (IIASA).*
- Disaster risk management policy in China, *Yuanchang Zheng and Jianguo Mu (Department of Disaster and Social Relief, Ministry of Civil Affairs).*
- The French experience in natural catastrophe risk management, *Suzanne Vallet (Caisse Centrale de Réassurance).*
- Earthquake risk management policy in Indonesia, *Werner Bugl (PT Asuransi, MAIPARK Indonesia)*.
- Disaster risk management policy in Mexico, *Carlos Bayo Martinez (FONDEN).*
- Disaster risk management policy in the Philippines, *Ronald I. Flores (Department of National Defense, Office of Civil Defense, National Disasters Coordinating Council).*
- Disaster management in India, *D. Madan (Under Secretary, National Disaster Management Division, Ministry of Home Affairs, Government of India).*
- Management of extraordinary risks, including terrorism, in India: achievements and perspectives, *C. S. Rao (Indian Insurance Regulatory and Development Authority).*

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* Background Note of Mr Kawachimaru's presentation (NIPPONKOA Insurance Company Ltd), based on *Governmental Earthquake Insurance System in Japan*, from *Earthquake Insurance in Japan*, written and published in March 2003 by Non-Life Insurance Rating Organization of Japan.

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