PART I

Chapter 7

Terrorism Insurance : An Overview of the Private Market

by
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This chapter provides an overview of the scope and evolution of the market and capacity for terrorism risk insurance before and after 9/11 events. It also examines the coverage currently available for this risk, the practical and theoretical advantages of such a private cover and its prospects.

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1. The Past

1.1. Small market mainly Lloyd's and AIG

During the 1970's and 1980's, terrorism insurance was largely in the hands of a small number of political risk underwriters - predominantly Lloyd's and AIG - who also offered riot and terrorism cover.

It was fairly unusual to offer stand alone terrorism coverage and it was mostly given as an extension to asset confiscation policies.

1.2. Limited regular demand: Colombia, Israel, Indonesia, Sri Lanka, South Africa, UK

Policies were mostly sold in loss active countries such as Colombia, Israel, Indonesia, Sri Lanka, South Africa and post-1992 in the United Kingdom.

1.3. Old fashioned insurance products

Short, clumsy wordings were used for decades that were deficient in many ways and for example failed to define important terms such as terrorism or distinguish other political violence perils.

2. 9/11

2.1. Terrorism exclusions in every policy

As a result of the fear and panic amongst ordinary property insurers, terrorism was excluded from virtually every possible policy, however genuinely exposed it was.

The insured loss from WTC was approximately $35billion but it is worth pointing out that the recent storms in the USA and Caribbean may cost a similar amount.

However because the peril is more familiar, there is no call from governmental bodies for natural perils insurance to be further taken out of the hands of insurers, as is in some quarters true for terrorism.

2.2. October 2001 : Lloyd's releases new T3 terrorism product

As a result of the entrepreneurial freedom within Lloyd's and notwithstanding large losses to the market, a new product known as T3 was released in October 2001, one month after the attacks in New York.

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2.3. Private market capacity $100m per risk/200m p/blast zone

In the early months of 2002, capacity was a mere $100million per risk/200million per blast zone.

With fairly low initial capacity, the product was priced in expectation of the next and imminent attack on the scale of WTC.

Critics of the private market incidentally often say that prices were "high" post-WTC whilst simultaneously saying that data was inconclusive and correct pricing hard to determine, which rather calls into question the certainty that the private market was charging "high" prices. Hindsight and the lack of large losses since WTC are wonderful things.

2.4. Massive demand from USA, Europe, Australia, Japan and elsewhere

As the popular perception was also that new attacks were only a matter of time, the product was in demand worldwide.

3. The Present

3.1. $2billion per risk/4billion per blast zone

Since the early days post WTC, the market has expanded enormously. There is now up to $2billion per risk capacity and perhaps $4billion per event.

3.2. Competitive market: Lloyd's, USA, Bermuda

As the initial fear of daily or weekly attacks in Western countries has subsided, many previously nervous carriers have been drawn into the market. There is now very active competition-as well as co-insurance-between London, USA and Bermuda to the obvious benefit of the insurance buyer.

3.3. $120billion capital secures terrorism insurers

The capital behind the main players in the private terrorism market amounts to approximately $120 billion, easily sufficient to meet their obligations, even assuming a substantially increased frequency of loss.

3.4. Average prices reduced by 60% compared to immediately post-WTC

Average prices have reduced by up to 60% compared to the cost of insurance immediately after the attacks in New York. Net prices may often be as little as 0.02% of the values insured and this represents a well-priced product from the buyer's perspective.

4. Practical Advantages of the private market

4.1. Underwriting flexibility

One of the main advantages of the private market is underwriting flexibility.

Private market underwriters can distinguish between a mattress factory and a government office building, when trying to assess the likelihood and possible cost of a terrorist attack. They can consider security measures, such as controlled access, employee screening and building construction.

Through bespoke underwriting, insurers can look in detail at features such as commercial activity (is it military or defence related?) and exact location, including proximity to terrorist targets. Incontrast, Pool Re in the United Kingdom, for example, simply divides the entire country into Zones A, B, C and D.

Underwriters have access to security reports and intelligence which allow risk assessment to be modified and updated on a daily basis. This cannot be said of state run schemes, which once created are inflexible and very difficult to change, generally requiring government intervention.

4.2. Price flexibility

Private market underwriters can also offer price flexibility. As each risk is considered individually, low risks are charged a low premium and higher risks pay an equally appropriate premium.

Unlike a one size fits all government scheme, there is no requirement that a peanut farmer, for example, subsidises a higher risk such as a city centre building.

Although data is not as comprehensive as for natural perils, there is a large body of information on terrorist attacks going back up to 100 years, indicating where they happen, who carries them out, what is their motivation, what methods are used and what they cost. There is no shortage of analysis of both the underlying trends and practical consequences and not a few competing models in this area. All of this means that pricing and risk assessment is increasingly well-informed.

4.3. Established distribution and documentation

As essentially just another insurance line-albeit a topical and sensitive one-there is a tried and tested distribution mechanism for these products, often using international insurance brokers. Equally, there is an established process for fast production of policy documents so that terrorism cover is provided and evidenced like any other physical damage peril.

There is no additional government mandated bureaucracy.

4.4. Fast, efficient claims handling

As is true of the documentation process, claims handling and the use of loss adjusters for catastrophe risks such as earthquake and windstorm is well established. Many insurers are very experienced in dealing with major, geographically widespread losses involving multiple insureds. These skills are extremely transferable.

There is no lengthy wait for a bureaucrat to make a decision over whether or not an attack amounts to "terrorism". This is a decision for the insurer to make as soon as sufficient evidence is available.

Also, a victim of terrorism has only to pick up the telephone or e-mail to begin the process of recovery and indemnification for damaged assets, help in re-establishing his business or for that matter compensation for injured personnel.

The same is not necessarily true for government terrorism schemes, even if administered by insurers, because the insurers can only act to help their clients when they are certain that they are acting in accordance with the rules and decisions of the relevant scheme.

4.5. Product innovation

Some recent examples of new products offered by the private market are for terrorism public liability, contingent banking risks and cyber risks.

Unlike government terrorism compensation schemes in various forms, set out by statute, if a new demand arises, private market underwriters can begin to develop appropriate products immediately.

In response to such demand, we have developed terrorism public liability coverage, something only TRIA in the United States comes close to offering and then in a very limited form. We have also developed new terrorism related banking and cyber attack products.

Private market terrorism products are also routinely sold to fill in gaps and deficiencies in government terrorism schemes-such as the narrow definitions of terrorism under TRIA and Pool Re-or because the buyers are not confident that the government schemes will provide an adequate service or even certainty of claims settlement.

5. Ideological Advantages of the Private market

5.1. No compulsory purchase by unwilling property owners

Why should property owners be forced to insure their own assets-as distinct from say third party liabilities-where they feel they can take responsibility or otherwise protect their financial position through different measures including self-insurance?

5.2. No compulsory sale by unwilling insurers

Why should insurers who know little about terrorism risk and have no interest in selling it be forced to include a coverage that they have no idea how to price and particularly when specialist alternatives exist?

Why also should insurers be forced to deal with the cumbersome bureaucracy inherent in to the government systems and financial risk of government reinsurance failure if they fail to comply with the rules in some way?

5.3. No taxpayer subsidy of private, commercial risk

Why should our taxes go to subsidise private, commercial risk? This is what is happening where governments reinsure or mandate insurance at tariff rates far lower than free, commercial markets would charge or below actual loss cost.

6. The Future

6.1. Stable, effective world market for terrorism risks

As more policies are sold, more loss data becomes available and trends become clearer, the private terrorism market will become even more stable and predictable in terms of pricing and coverage.

6.2. Increased broker access to increased capacity

As more brokers become familiar with the products, it will become even easier for supply to meet demand. As long as there is some margin to be made in selling terrorism insurance, capacity will continue to be drawn in.

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6.3. Competitive market subject to strong reserving

The competitive market is set to remain, however pricing must not become complacent and the maintenance of strong balance sheets, so as to better deal with the inevitable losses is vital.

6.4. Claims to prove the worth of the products and the service

It is an old, dull but probably correct aphorism that the worth of an insurance policy only becomes evident when a claim is made. Whilst none of us wish to see terrorism claims, the truth is that more attacks in Western countries are highly probable. When this happens, the private terrorism market will have an opportunity to demonstrate just how good its claims service can be and just how valuable are the products.

6.5. Private terrorism market accepted as a viable, long-term catastrophe market

From the author's point of view, it is desirable to develop the private terrorism market in reach and financial strength and to accept it as a traditional catastrophe insurance market in which underwriters try to put a price on the vagaries of nature, manifested in hurricanes, earthquakes and volcanic eruptions.

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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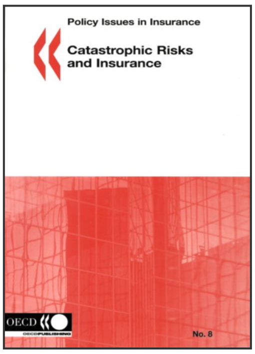

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