MARSH

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CLIENT ALERT

2015 REVIEW OF THE AUSTRALIAN TERRORISM INSURANCE SCHEME

IN THE WAKE OF THE TERRORIST ATTACKS IN THE US ON 11 SEPTEMBER 2001, THE AUSTRALIAN FEDERAL GOVERNMENT ESTABLISHED A TERRORISM INSURANCE SCHEME FOR COMMERCIAL PROPERTY, BUSINESS INTERRUPTION AND PUBLIC LIABILITY. ITS PURPOSE WAS TO MINIMISE THE ECONOMIC IMPACTS FROM THE WITHDRAWAL OF TERRORISM INSURANCE.

BACKGROUND

The Terrorism Insurance Act 2003 (TIA) was enacted by the Commonwealth Government and the Australian Reinsurance Pool Corporation (ARPC) was established to develop and administer a reinsurance scheme. The terrorism insurance scheme started on 1 July 2003.

The TIA operates by overriding terrorism exclusion clauses in eligible insurance contracts[i] to the extent losses excluded are eligible terrorism losses arising from a declared terrorist incident (DTI)[ii] affecting eligible property[iii] located in Australia.[1] This requires insurers to meet eligible claims in accordance with the other terms and conditions of their policies.[2]

Through the scheme, insurance companies can choose to reinsure the risk of claims for eligible terrorism losses by paying reinsurance premiums to ARPC at rates set by the federal government.[3]

REVIEW OF THE SCHEME

A review of the scheme happens every three years. The inaugural review took place in June 2006 and further reviews were completed in 2009, 2012 and 2015. Treasury started the latest review of the TIA in September 2014, The report from which was released in December 2015 ('the Review').

The Review considered matters of ownership, administration, fee retention, funding levels returned to government, premiums and scope and coverage of the scheme.

The Review found market failure still exists in the Australian terrorism reinsurance market and the ARPC should remain in place under the current ownership structure and administration. The Review makes a number of specific recommendations, summarised at Appendix 1 of this alert. Several points of interest for policyholders are highlighted below.

PREMIUM PRICING (*RECOMMENDATION 8*)

The reinsurance premium charged by ARPC is determined by Ministerial Direction and is set by postcode into three tiers according to population density.[4]

The reinsurance premiums charged to insurers by the ARPC will increase from 1 April 2016. This is the first time premiums have increased. This is a necessary step, according to the review, to maintain the financial sustainability of the scheme.

1 The Australian Government the Treasury, *Terrorism Insurance Act* – Review: 2015 (2015) 5.

2 Ibid.

3 http://arpc.gov.au/

4 Tier A is CBDs of cities with populati ons over one million. Tier B is urban areas of all state capitals plus cities with populations over 100,000 such as Newcastle, Geelong and Wollongong. Tier C i s all other areas of Australia. (The Australian Government the Treasury, *Terrorism Insurance Act – Review: 2015* (2015) 22.)

Class of Insurance	Current Rate (from 1 October 2003)	New Rate (from 1 April 2016)
Eligible Property and Business Interruption		
Tier A (Major City CBD)	12%	16%
Tier B (Mostly suburban areas)	4%	5.3%
Tier C (Mostly rural areas)	2%	2.6%
Public liability (as owner or occupier of eligible property)	N/A	N/A

MIXED USE (RESIDENTIAL AND COMMERCIAL) AND HIGH RISE RESIDENTIAL BUILDINGS (*RECOMMENDATION 9*)

Currently the threshold for determining whether property is eligible under the scheme is at least 50 per cent of floor space being used for commercial purposes.

The Review recommends the scope of the scheme be extended so it applies to:

a. buildings in which at least 20 per cent of floor space is used for commercial purposes; and

b. buildings with a sum-insured value of at least $50 million, whether used for commercial or other purposes.[5]

COVERAGE FOR CERTAIN LOSSES (*RECOMMENDATION 10*)

Once a terrorism incident has been declared, the TIA operates to render terrorism exclusions in eligible insurance contracts of no effect.[6] Section 8(2) of the TIA defines a terrorism exclusion as an exclusion or exception for either acts that are described using the word 'terrorism' or 'terrorist' or words of similar effect; or other acts that are substantially similar to terrorist acts as defined in section 100.1 of the *Criminal Code*.

Many insurance contracts contain a range of general exclusions that exclude cover for losses from events like chemical, biological and nuclear explosions, pollution or contamination, the destruction of electronic data, or the effects of micro organisms. Doubt has arisen as to whether such exclusions constitute terrorism exclusions as defined by the TIA. This is because these exclusions do not use words like 'terrorism' or 'terrorist' or other words that specifically refer to events like terrorism, but rather merely exclude losses of a particular class of event.[7]

On this basis, losses could be effectively excluded even where they came about as the result of events declared to be terrorist incidents under the TIA.[8] The Review recommends the lack of clarity surrounding exclusion for terrorist attacks that use chemical or biological means be resolved as soon as possible.[9] The framework for resolving this issue has yet to be announced.

SUMMARY

The 2015 Review has resulted in a number of recommendations that will impact policy holders. The ARPC has announced it will be undertaking extensive stakeholder discussions to ensure implementation of the recommendations is well understood by the insurance market.

The final report can be viewed on Treasury's website: Terrorism Insurance Act Review: 2015.

(http://www.treasury.gov.au/PublicationsAndMedia/Publications/2015/Terrorism-Insurance-Act-Review-2015)

5 Ibid 25.
6 Ibid 27.
7 Ibid.
8 Ibid.
9 Ibid 28.
10 Treasury material used 'as supplied'.

APPENDIX 1
2015 REVIEW RECOMMENDATIONS[10]

Structure of the ARPC

Recommendation 1: The Act remains in force, subject to future three-yearly statutory reviews.
Recommendation 2: The current administration structure of the ARPC as set out in the Act is retained.

Retentions

Recommendation 3: The four per cent rate of gross fire and industrial special risk premium (less any fire services levy) should be increased to five per cent.
Recommendation 4: Current maximum retention levels for individual insurers should be removed.
Recommendation 5: The maximum industry retention should be increased from $100 million to $200 million.

Retrocession

Recommendation 6: The ARPC continues to have the discretion to purchase retrocession, subject to the ARPC assessing the need for, and levels of, its retrocession program and value for money.

Fee for the Government Guarantee

Recommendation 7: The ARPC pays to the Commonwealth each year, commencing in the 2016-2017 financial year:

a. a fee of $55 million with respect to the Commonwealth guarantee of the ARPC's liabilities; and

b. an additional amount of $35 million a year to reflect the Commonwealth's support in making the ARPC reserves available for payment of claims.

Premiums

Recommendation 8: The premiums charged by the ARPC be increased, with effect from 1 April 2016 to:

- 16% for Tier A.
- 5.3% for Tier B.
- 2.6% for Tier C.

Scope of the Scheme

Recommendation 9: The scope of the scheme be extended so it applies to:

a. buildings in which at least 20 per cent of floor space is used for commercial purposes; and

b. buildings with a sum-insured value of at least $50 million, whether used for commercial or other purposes.

Recommendation 10: The application of the Act be clarified by amendments that remove doubt about whether certain losses would be covered under the scheme. These include losses attributable to terrorism attacks that use chemical or biological means.

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i. Sections 6-8 of the TIA

ii. Section 7(1) of the TIA provides that a contract of insurance is an eligible insurance contract to the extent that it provides insurance cover for one or more of the following:
(a) loss of, or damage to, eligible property owned by the insured;
(b) business interruption and consequential loss arising from: (i) loss of, or damage to, eligible property that is owned or occupied by the insured; or (ii) inability to use eligible property, or part of eligible property, that is owned or occupied by the insured; or
(c) liability of the insured that arises out of the insured being the owner or occupier of eligible property.

iii. 'Eligible property' is defined under section 3 of the TIA as the following property that is located in Australia:
(a) buildings (including fixtures) or other structures or works on, in or under land;
(b) tangible property that is located in, or on, property to which paragraph (a) applies;
(c) any other property prescribed by the regulations.
Note that there is a range of exclusions set out in the *Terrorism Insurance Regulations 2003*

10. Treasury material used 'as supplied'.