

### TERRORISM INSURANCE: WHO INSURES AND WHO IS INSURED

Terrorism insurance is designed to cover potential losses and liabilities that might occur as a result of terrorist activities. Before the events of 11 September 2001 in the US, terror risks were often covered by private insurers – or at least not specifically excluded – in property insurance. After these events there were many changes in the global terrorism insurance market with a trend among global insurers towards excluding terror coverage from their contracts. Many governments have, however, become more involved in mitigating the risk exposure of insurers by developing explicit schemes or terror pools to address terror risks.<sup>1</sup> These developments raise questions about who could face losses caused by terrorism activity. This box describes who provides terrorism insurance and who is insured in the euro area.

Several sectors could potentially be faced with large financial losses as a result of terrorism:

- i) Households and corporations with insufficient insurance coverage
- ii) Insurance companies which are unable to reinsure or transfer risks to capital markets via securitisation, which are active in markets without a government backstop, or which are members of terror pools created to spread insurance risk.
- iii) Reinsurance companies which are unable to shed exposures to other reinsurers or capital markets via securitisations, or are active in markets without a government backstop.
- iv) Governments providing backstop for the terrorism insurance market.

Many households and companies can face large losses, mainly on residential and commercial property and aerospace damages, as a result of a terrorist event. For households or companies, the decision to purchase terrorism insurance depends both on their perception of the risk and whether or not there are specific requirements, such as clauses in loan covenants or commercial mortgage agreements or, indeed, if taking out such insurance is made compulsory by governments. Households and companies can sometimes be forced to bear the risk of losses from terrorism, as insurance policies that provide coverage for terrorism losses are sometimes hard to obtain. Furthermore, consumer understanding of the coverage provided in a policy is often limited, as general insurance policies are frequently bought on the basis of price alone.<sup>2</sup>

For insurance companies, terrorism insurance is considered to be a difficult product to construct and price. This is because the odds of terrorist attacks are very difficult to predict but the potential liabilities can be enormous. For example, the 11 September 2001 attacks resulted in an estimated USD 32 billion of losses. Many insurance companies therefore exclude terrorism from property insurance coverage, or else they require endorsements to provide coverage. Insurers (or reinsurers) that do provide coverage for losses caused by terrorism may have difficulties in passing the risks on to reinsurers, as the availability of reinsurance is sometimes low.

1 See also Guy Carpenter (2007), “Global Terror Insurance Market”, June. A terror pool typically functions as a reinsurance whereby primary insurers issue separate terrorism policies that are ceded to the terror pool. Losses facing the terror pool are typically borne by the insurers participating in the pool in relation to their market share.

2 See, UK Financial Services Authority (2007), “Financial Risk Outlook”, January.

Furthermore, the insurance securitisation market is still under development – no bond which would generate cash-flows following terrorist events has yet been issued – and not large enough to spread the huge potential losses from terrorism events.

To provide relief for insurers offering terrorism insurance and to support the supply of insurance policies that include terrorism insurance, several euro area and other countries have developed government and insurance industry wide programmes for terror coverage. In the euro area the type of arrangement and coverage provided for terrorism insurance varies (see Table). Most countries have established some sort of terror pool or government sponsored insurance entity to spread losses across primary insurers and reinsurers. In addition, many governments provide large and sometimes unlimited guarantees over and above the losses than can be borne by terror pools or government sponsored insurance entities. The main reason why governments often offer guarantees is that large losses from terrorism can have economic domino effects as insurers could be faced with insufficient financial resources to cover all claims. Furthermore, many observers believe that the government could have no choice but to provide aid to households, companies and insurers who suffer devastating losses from terrorism, even if they are not insured.<sup>3</sup>

3 See R. W. Ferguson (2007), “The Need to Extend the Terrorism Risk Insurance Act”, testimony before the US House of Representatives, 5 March.

Table Terrorism insurance coverage in selected euro area countries

Country	Type of terrorism insurance programme	Distribution of potential losses
Austria	Terror pool introduced in 2002. The terror pool functions as a reinsurance whereby the primary insurer issues a separate terrorism policy which is ceded to the terror pool.	The first € 50 million of annual aggregate losses is covered by primary insurers (in relation to their market share in property insurance) and the next € 150 million is covered by the international reinsurance market.
Belgium	Currently terrorism insurance is compulsory for workers' compensation, motor liability and fire policies. A law is expected to be introduced in 2008 to establish a terror fund and also make terrorism insurance compulsory for accident and health and life policies.	The first € 300 million (not yet fixed) of losses will be covered by primary insurers (in relation to market share). The next € 400 million will be reinsured. Losses between € 700 million and € 1 billion will be covered by the Belgian Government.
Finland	The Finnish Terrorism Pool includes all Finnish insurance companies except two. The pool is intended as a last resort in the event of major terrorism loss.	Coverage will be available under the terrorism pool only after all traditional reinsurance programmes have been exhausted.
France	French legislation requires all property insurers to provide terrorism coverage. In January 2002 a terror pool was set up by the public authorities and France's two main insurance associations. There is a distinction between small risks (the responsibility of traditional reinsurers) and medium and large risks (terror pool responsibility).	The first € 400 million of losses is shared by the members of the pool (in relation to market size). Losses between € 400 million and € 2.2 billion (2.4 billion for small risks scheme) are reinsured. Unlimited state guarantee of losses above € 2.2 billion (2.4 billion in the small risks scheme).
Germany	Terrorism insurance is generally included in policies. To reduce the vulnerability of insurers in 2002, a specialist company covering terror-related property damage called EXTREMUS was created by the Government and the Association of German Insurers. The primary objective of EXTREMUS is to protect medium-sized companies against property and business interruption losses caused by terrorism.	The first € 2 billion is covered by primary insurers and domestic and foreign reinsurers. Losses between € 2 and 10 billion are covered by state guarantee.

**Table Terrorism insurance coverage in selected euro area countries (cont'd)**

Country	Type of terrorism insurance programme	Distribution of potential losses
Italy	There is currently no terror pool or government involvement in terrorism insurance. The creation of a specific pool is, however, being considered by the Government. The majority of insurance policies covering property damage in Italy exclude terrorism risks where the sum insured exceeds € 50 million.	
Netherlands	The Dutch Insurers' Association and the Government created a dedicated reinsurance company in 2003 to provide terrorism insurance.	The first € 400 million of losses is covered by a dedicated reinsurer to which the primary insurers have ceded policies. Losses between € 400 and 950 million are reinsured on international reinsurance markets and losses in excess of € 950 million are covered by the Dutch Government.
Portugal	There is currently no terror pool or government involvement in terrorism insurance. Terrorism is typically not included for personal or commercial lines.	
Spain	Coverage for "extraordinary risks" such as natural catastrophes and political risks (including terrorism) is compulsory, and the government-owned entity Consorcio de Compensación de Seguros (CCS) provides guarantees for such risks to the extent that they are not insured privately.	If claims exceed the CCS's resources, an unlimited state guarantee is available.

Sources: Guy Carpenter and ECB.

Several euro area insurers and, in particular, reinsurers are very active in the US and the sale of terrorism insurance policies in the US is therefore also important for euro area insurers. In the US the Terrorism Risk Insurance Act (TRIA) was first introduced in 2002 as a response to the 11 September 2001 events and it was extended in December 2005.<sup>4</sup> It provides a federally financed financial backstop for commercial insurers facing potential insolvency arising from underwriting terrorism risks. The TRIA is due to expire at the end of 2007, but most political analysts expect the TRIA to be replaced by a long-term federal programme for terror cover, probably based on the current TRIA. However, a change in terrorism exposure, depending on the US legislation, could result in increased earnings volatility and significant risks for euro area insurers and reinsurers, as private reinsurers are unlikely to fill the reinsurance capacity void should the TRIA not be extended.<sup>5</sup>

All in all, the identities of who insures and who is insured against losses caused by terrorism varies widely across euro area countries as the nature and coverage of terrorism insurance and government support varies. Households and companies might not be aware that terror coverage is sometimes not included in insurance policies and run the risk of unexpected losses, or they might find it difficult (owing to lack of availability of terrorism insurance) or too expensive to insure themselves against losses from terrorism. Euro area insurers are therefore exposed to different degrees to risks from losses caused by terrorism. In general, reinsurers are more exposed to potential losses because terror coverage is often reinsured. In addition, governments are also exposed to a varying degree to potential losses, depending on the guarantees they provide.

<sup>4</sup> See Marsh (2006), "Marketwatch: Terrorism Insurance 2006".

<sup>5</sup> See Moody's (2007), "Global Reinsurance Industry Outlook", September.