THE RETURN OF

Steve Coates examines the evolution of terrorism insurance since Pool Re's introduction and the options it can provide to captives moving forward

Geopolitical turmoil and heightened awareness of terrorism risk has put the terror threat at front of mind for risk managers and captive insurers.

In the context of this heightened focus, it is worth looking at the evolution of the insurance industry's response to terrorism and what the future may hold.

It is now 22 years since the IRA effectively created a new class of insurance. Until then property insurance policies in most markets around the world were silent on the peril of terrorism and importantly, it was not an underwritten peril in the sense that the underwriter gave it consideration or even charged any money for it.

Effectively cover was provided automatically within the fire and explosion perils and no apparent rating was applied for the terrorism element.

The IRA campaign had caused damage to commercial property in the UK during the 1980s which insurers had paid, most notably the Brighton bombing during the Conservative conference, but there was nothing like the catastrophic events that occurred in 1992 and later.

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The Baltic Exchange bombing in 1992 caused insured losses in today's money of approximately £500m, which comfortably exceeded the sum of all the previous claims for IRA attacks. This led to global reinsurers concluding they could no longer provide cover for UK terrorism and exclusions were applied from January 1993.

Lobbying by industry and insurers of Government resulted in the creation of Pool Reinsurance in January 1993, an industry mutual supported by an unlimited government loan facility. Shortly after this, another IRA bomb was detonated in the City, this time in Bishopsgate, and the insured cost of this was today's equivalent of £800m.

Pool Re dealt with a number of further IRA incidents during the 1990s, until the ceasefire and then the Good Friday agreement in 1998. The prospects for a return to a normal terrorism market then seemed positive. In 2001 however, the attacks on the World Trade Center changed everything, not just in the US and UK, but around the world.

The Al Qaeda effect

What Al Qaeda demonstrated, as indeed the IRA had before them, was that terrorism was a very different risk to just about all other insured perils.

There are a number of reasons for this, most notably the fact it is something created by humans and designed specifically to cause damage. This makes terrorism very difficult to model or predict in the same way as is possible with natural catastrophes.

We also have a significant amount of weather and natural catastrophe data, in addition to a century of loss data which is pivotal in informing how insurers and reinsurers deploy capital and charge premiums.

Post 9/11 the global insurance industry decided terrorism risk was highly uncertain and of a nature and magnitude that could not be predicted to any acceptable tolerance. The amount of capital they were willing to deploy was thus very small and governments all around the world had to step in, as had happened in the UK in 1992, and create a variety of vehicles to provide the additional capacity needed and ensure cover was available to those who needed it.

Most developed countries have some form of government support for terrorism and there are around 24 schemes or pools around the world. These vary in structure and nature, dependent usually on local requirements, and while all cover damage to property, some also extend to other classes such as workers compensation, motor and aviation.

Government reluctance

With all of these mechanisms having been created, one might argue the problem has been dealt with and insurers can move on. Unfortunately, as we all know that is not how the world works!

While governments provided the guarantees their insurance markets needed, they did this because they had to, not because it was something they wanted to do. Accordingly most governments would like to see a return to a normalised market where cover could be provided without their support.

Evidence of this can clearly be seen during the TRIA renewal last year when elements of the US Congress felt the market could support terrorism without government assistance. Congress ultimately accepted that government assistance was still required in order to fulfil demand for terrorism cover and TRIA was ultimately renewed, but the debate was a good indicator of how other governments might approach this in time.

There are two other important issues that are relevant to how future cover for terrorism might be provided. Firstly, after 9/11 much resource and intelligence has been dedicated around the world to interdicting future terrorist plots and destroying terrorist organisations.

From the perspective of property damage this has broadly been successful as any plots that have succeeded have caused little damage to property. The types of terrorist plot that cause significant damage to property require planning, resources and people and in general the counter-terrorism agencies find it easier to intercept larger plots than say those involving a lone wolf.

Moreover, one only has to look at the changes to airport security and aircraft cockpit access to see that it would now be much more difficult for a terrorist to gain control of a plane (s) and use the aircraft as a weapon as happened on 9/11.

Thus since 2001 there have been very few successful terrorist attacks on property, though there have been many plots disrupted or interdicted, and this has contributed to the other important issue, that of market capacity.

Post 2001, no investor really wanted to put very much capital at risk in order to write terrorism cover. Since then underwriters have seen a number of factors change. The chances of a terrorist plot being successful seems to have reduced in light of increased focus and security as described above.

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In itself this is very different to other perils such as natural catastrophes where our ability to predict them might be better, but we have zero chance of preventing the event happening at all. Furthermore if terrorists are successful once, a second event is even more unlikely given the increased security that inevitably follows.

So underwriters now see terrorism, and indeed related perils such as war and political risks, as a more attractive proposition than it was a decade ago and though terrorism still cannot be modelled and predicted accurately, the tools are much more credible than they were in 2001.

Certainly deterministic loss modelling (looking at the cost of different types of event when they happen, not their chances of happening or frequency) has evolved to the extent that they are now viewed as credible and have facilitated the emergence of increased capital to terrorism and related perils.

Part of the reason for this additional capital is that terrorism does not correlate with what tend to be reinsurers largest event scenarios – natural catastrophes such as hurricane, storm and earthquake. So writing a single peril (terrorism) restricted to a single territory offers the type of diversification usually given credence in capital formulas.

Growing flexibility

At a time when there is significant levels of additional capital coming into the global insurance industry, terrorism is viewed by many as offering a high-severity, low-probability but high-return equation, that also gives diversification from the usual peak risk such as US hurricane and earthquake, which is where much of the new capital has ended up being deployed.

Pool Re has recently tapped into the more positive sentiment for terrorism by placing a £1.8bn retrocession programme led by Munich Re. This protects the assets of the scheme and distances the UK taxpayer further from the risk.

This is nowhere near enough cover to fulfil all UK demand for terrorism cover so government assistance is likely to be required for some time yet. However it reintroduces the market which once again wants to write UK terrorism and this creates a pathway for that participation to increase over time.

From a captive perspective the possibility of more capacity and choice is a good thing. Most government supported schemes, such as those in UK and US, allow captive participation but tend to provide fairly comprehensive cover and that has a price.

Some of the new capacity is content to allow cover to be tailored to the requirements of some captives and this can mean savings in premium.

Terrorism might always be viewed as different to natural, or non-manmade perils, but modern modelling techniques combined with concerted preventative measures by governments, could have created some light at the end of the tunnel.

Terrorism is now seen as an opportunity that must be examined closely, and that in itself represents a seminal milestone.