A Legal Framework: Terrorism and Insurance

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“Both terrorism and insurance sell fear -- and business is business”

By Liam McCurry

Abstract:

In India though there are many laws dealing with insurance sector, there is no particular law to govern insurance coverage to loss occurred by terrorists activities. It is very difficult to estimate the risk involved and amount of premium for individuals. Group life insurers provide coverage for acts of terrorism because the businesses that purchase group life insurance demand that they do. Coverage for acts of terrorism is too expensive at present. What can be done to make it available to all and affordable? Availability and affordability issues in some geographic areas, such as metropolitan areas which are susceptible to terrorism attacks would be different. It is necessary to analyze the position in other countries to design a program for India.

Key Words: Terrorism, risk, premium, life, program, estimate.

Statement of Problem: Insurance or assurance means to assure another person to pay the latter or his representatives to pay a certain fixed amount on happening of a certain event or on expiry of a certain period of time. There was no concept of insurance under the Vedic period. This concept came to India during British rule. In India the basic law is found in the Insurance Act 1938. It has been amended a number of times. Apart from the Act 1938 there are other laws too viz. The General Insurance Business (Nationalization) Act, 1972; The Life Insurance Corporation Act, 1956; The Marine Insurance Act, 1963 and The Insurance Regulatory and Development Authority Act, 1999. Insurance is a form of risk management. It is transfer of risk from one entity to another in exchange of premium. It could be used to guarantee a small or a large, devastating loss. The institution of insurance protects from future possible loss of life or property, however recently ‘terrorism’ which has caused tremendous loss of life and property globally, has no separate law.

Meaning of Terrorism: Terrorism has no international definitions, but United Nations tried to find an acceptable definition for it. Under Resolution 1566, it defines terrorism as follows: Criminal acts, including against civilians, committed with the intent to cause death or serious bodily injury, or taking of hostages, with the purpose to provoke a state of terror in the general public or in a group of persons of particular person, intimidate a population or compel a government or an international
organization to do or to abstain from doing any act. It can be said that terrorism is an unlawful use of force. It is a kind of violence which could be made by one person or an organized group. It could be done against people’s life or their property, with intention to intimidate society or government. There are different reasons for terrorist attacks like political reason, social reason or ideological reason. It is completely different from the criminal acts which done for other reason for example, retaliation.

**Risk Management at Affordable Cost:**
Human society has been concerned about both natural and man-made disasters for quite some time. Terrorism is a peril that has a human element of an unpredictable nature. So there should be a terrorism insurance implementation working group to meet and discuss long-term solutions to address the risk of loss from terrorist acts. Some innovative ideas are required in this field. But what are the key factors that will determine the availability and affordability of terrorism risk insurance coverage? And how can these factors be measured and projected?

To reduce the cost and to increase availability of coverage for acts of terrorism, insurers need to be able to accurately estimate their ultimate expected loss costs associated with the risk transfer and related costs of capital. To do so requires knowledge of both the expected frequency and severity of future losses. In the case of coverage for acts of terrorism, severity and to a greater degree frequency, are extremely difficult to predict. Life insurers need to be able to accurately estimate their ultimate expected losses from acts of terrorism if they are to be able to continue to make group life insurance available at affordable prices. They will also need to find a way to manage their probable maximum loss and purchase affordable catastrophe reinsurance to assure that they remain solvent. To do so requires knowledge of both the expected frequency and severity of future losses. In the case of coverage for acts of terrorism, insurers either need to develop a historical record of frequency and severity of losses or find another alternative way to accurately measure expected losses. When insurers are unable to determine what price to charge, they understandably tend to restrict coverage. With limitations in place, insurers can more reasonably assign a price to coverage that will not threaten their

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2. Response to President’s Working Group on Financial Markets Terrorism Risk Insurance Analysis. p. 1
3. ibid. p. 9
solvency and will place them in a better position to make such coverage available\textsuperscript{4}. Mitigation in terrorism risk is also difficult to evaluate, since it doesn’t completely lend itself to traditional mitigation efforts. Insureds can mitigate against potential fire losses by installing sprinklers or against potential windstorm losses by installing shutters and strengthening roof tie-down hardware. However, while insureds have taken steps to enhance individual building security, install metal detectors, erect concrete barriers around building perimeters, etc., the losses that ensue from a terrorist event can include nuclear, biological, chemical or radiological events, which are extremely difficult to mitigate\textsuperscript{5}. Unfortunately, there is no empirical measure of availability and affordability since they are both subjective measures and intertwined concepts in most cases. It can be argued that coverage for every peril is available to anyone if they are willing to pay any price. However, as a practical matter, if businesses perceive that coverage for acts of terrorism is too expensive for the risk of loss presented, they will choose not to buy the coverage. Further, if insurers perceive that not enough is known about the frequency or severity of losses caused by acts of terrorism, they will choose not to make the coverage available, unless either the state or federal government forces them to do so.

To cope with this problem insurers have been attempting to diversify their terrorism risk, which is a fundamental element in the theory of risk management. This trend will continue into the future, but it may also cause some availability and affordability issues in some geographic areas, such as metropolitan areas that are seen as susceptible to terrorism attacks.

Insurers now consider proximity to a known or perceived target risk in deciding whether to write a particular business. They also consider whether a business has a large number of employees at a single location. This is particularly true for lines of business that have a risk of concentration such as workers’ compensation and group life. With a few exceptions, most laws in this regard do not allow an insurer to exclude or limit worker’s compensation coverage. As a result, an insurer underwriting this risk without adequate reinsurance is subject to a large potential loss if there are a significant number of employees at a single location\textsuperscript{6}.

**Insuring the Group:** Group life insurance is purchased by business to provide protection for their workers. But unlike worker’s compensation, there is no

\textsuperscript{4} Ibid. p. 1.
\textsuperscript{5} Ibid p. 4.
\textsuperscript{6} Ibid p. 1.
statutory requirement for group life that prohibits an insurer from limiting available coverage for acts of terrorism in some fashion. So it could be written with exclusion for deaths caused by acts of terrorism. However, the employer, the insurer, the insurance industry in general and the national economy would suffer if an insurer is only able to pay a fraction of the policy face amount in a mass casualty situation. This outcome is not one that is desirable to either business owners or employees and their families. Although there is some level of private reinsurance available for group life coverage, it is not sufficient to cover a catastrophic terrorism loss situation. So the lack of adequate affordable reinsurance coverage for group life insurers will lead them to eventually amend contract language to limit the number of lives that can be covered from a single event. This might manifest itself in the form of an aggregate coverage limit to an employer.

One of the most important improvements which have been taken place in the ability of insurers to price terrorism risk insurance includes the use of modeling. Computer modeling of terrorism risk has been developed and refined by risk modelers in an attempt to measure an insurer’s risk of loss from acts of terrorism. Many insurers have begun to use the computer simulation models to assist them in pricing. While these models provide insurers with additional information about their risks and may provide more validity to premium rates in the future, the accuracy of models particularly with respect to frequency remains uncertain.

While some computer simulation modeling has been introduced, the modeling efforts and their results are untested. The models are based on the opinions of counterintelligence experts along with assumptions regarding the type of damage that would occur if certain weapons were deployed. Insurers have relied upon them because they have no other choice. Insurers continue to express reservations about their ability to measure the risk of loss from acts of terrorism largely because even though modeling might be able to estimate the severity of loss resulting from specific terrorist events, there is no way to determine the frequency of such events. Unlike weather events or seismic events, which are outside human control and which occur with some statistical regularity, terrorist events are solely dependent on the will of those who seek to carry them out and the effectiveness of those who seek to prevent them. Thus, the insurance industry is left with very little on which to base

7. ibid p. 2.
8. ibid p. 8.
frequency, and even the most sophisticated terrorism models amount to little more than educated guesses.\(^9\)

The availability and cost of reinsurance clearly play a role in insurer’s decisions also. If insurers could effectively share much of the risk of loss for acts of terrorism, they would, and things would be fine. But there is limited capital available that reinsurers wish to devote to insuring acts of terrorism.\(^10\) The private reinsurance is used to provide coverage for primary insurers’ retention and loss-sharing. Over the long-term Reinsurance Associations testified that projected growth under favorable loss experience would be very modest and will not fill the capacity needs of the primary insurance market. Additionally, the Reinsurance Associations testified that reinsurers are only able to provide limited capacity for terrorism because the potential losses would otherwise place these companies at risk of insolvency. Reinsurers’ capital is necessary to support all outstanding underwriting commitments including natural disasters, terrorism, workers’ compensation and other casualty coverage. The Reinsurance Association also noted that Chemical Nuclear Biological Risk (CNBR) reinsurance coverage is limited and expensive when available.\(^11\)

In the past, the insurer would have purchased catastrophe reinsurance protection against the possibility of a large number of covered lives being lost in a single event. A typical reinsurance policy would have protected the company against the loss of more than three lives in a single event.

But now the world is different. If reinsurers exclude coverage for terrorism or limit the aggregate amount of catastrophe reinsurance that they are willing to provide, the primary insurer must now decide whether they should continue to insure this group. While it appears that life insurers are continuing to offer coverage for group life exposures, the constriction in the catastrophe reinsurance market leaves the primary insurer exposed to losses that would have been covered by them.\(^12\)

Insurers and insurer trade associations may argue that the problem with providing coverage for acts of terrorism is related to rate regulation. However, there is no rigorous rate review regime because the prevailing regulatory philosophy is that sophisticated insurance buyers and sellers do not require assistance from regulators to conduct business. Thus commercial

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9. ibid p. 2 &3.
10. ibid p 3.
11. ibid p. 4.
12. ibid p. 8.
property and casualty rates are largely unregulated. Insurers have indicated that coverage for acts of terrorism may be more widely available in the absence of rate regulation. This notion is disabused when one looks at the appetite for providing reinsurance for acts of terrorism. Reinsurers are free to price their products as they see fit, yet they are unwilling to meet the demands of the primary insurers. But what is the role of captive insurance companies? Pure captive insurers accept risk transfers from their parent corporation and its subsidiaries. The use of a pure captive does nothing to spread the risk of loss from an act of terrorism. It is simply borne by the corporation, but managed through its captive. Since captive insurers generally reinsure their exposures in the same reinsurance market as primary insurers, there is no potential benefit to using captive insurers to insure terrorism risks. However, captives to a great extent protect the parent from the vagaries of the marketplace after disasters in terms of pricing and continuation of coverages.

Group life insurers provide coverage for acts of terrorism because the businesses that purchase group life insurance demand that they do. No employer wants to tell employees that their benefit package is reduced this year because if they are killed by an act of terrorism, their life insurance coverage no longer applies. Imagine the good will that would be lost if the business suffered casualties from an act of terrorism and they had to inform surviving spouses that no compensation was forthcoming. That alone could ruin the business enterprise.

However, it should be noted that, the insurers have always excluded nuclear events. Not only the nuclear events but the radiological losses have been excluded from policies. So it appears that insurers are unwilling to provide coverage for CNBR events caused by acts of terrorism even with the federal loss sharing program. But why?

The magnitude of potential CNBR losses is so great that it does not conform to the traditional methods available to insurers to spread and share the risk. The limited amount of capital available in the industry to insure all commercial losses is considered to be inadequate to cover a large-scale CNBR event. A CNBR event has the potential to affect a large geographic area implicating concentration of risk considerations that may have substantial implications for individual insurers. Nuclear Biological Chemical Risk, or CNBR, has to be dealt with...

13. ibid p. 6.
14. ibid p. 5.
15. ibid p. 9.
explicitly. For one thing, a dirty bomb for example could cause more loss to individual homeowners than to business. And of course the sheer magnitude of a potential CNBR loss implies separate treatment in a stand-alone program or as part of a combined one\textsuperscript{16}.

Unless a way is found to dedicate substantial capital to these events, the industry will remain reluctant to make coverage available and affordable. As stated above, these losses present a catastrophic exposure to an industry with limited capital and are difficult to mitigate using traditional methods of risk management and loss control\textsuperscript{17}.

**Present Scenario in India:** Following the recent Terror attacks, the Insurance Regulatory and Development Authority (IRDA) expects new and innovative policies to provide cover against such terrorist activities. IRDA ex-chairman J Hari Narayan said. “Terror insurance products are bound to be upgraded and the rate of premium might change depending upon the evolution of new products that the industry may come up with\textsuperscript{18}.”

In India, the Terror Insurance Pool is the final authority in handing out insurance claims related to terror attacks. So Indian insurance companies contribute the premium they charge on providing cover against terrorism to a common fund, from which all terror-related claims are paid. The Pool was set up when the global reinsurance market withdrew all terrorism protection.

With reinsurance rates hardening, the Indian insurance companies felt the need to set up a pool so that in case of any eventuality, they could fall back on their own domestic pool and not depend wholly on global reinsurance. Moreover it was difficult for any one company to take on the entire risk related to terror attacks and hence the concept of the pool emerged\textsuperscript{19}.

As we can see, the Indian general insurance industry had set up its independent terrorism pool after the 9/11 attacks on the US with the General Insurance Corporation (GIC) managing the pool. In contrast, the developed world had to rely on individual governments to establish a separate terrorism pool to take care of probable contingencies.

Hari Narayan said: All claims arising from any terrorist activity are furnished through the terror insurance pool formed by general insurance companies in 2001. The pool, which has a corpus of over Rs 1,000 crore, allows an insurer to withdraw to the extent of Rs 750 crore per location. However, this

\textsuperscript{16} ibid p. 12.
\textsuperscript{17} ibid p. 13.
\textsuperscript{18} Terrorism insurance pool set to expand, ENS Economic Bureau.

\textsuperscript{19} DNA Money, 4 Dec 2008
pool will grow as insurance companies are bound to be buffeted by growing insurance claims\textsuperscript{20}.

In India, the terrorism risk premium pool is mainly managed by the General Insurance Corp (GIC). Premium collected by the non-life insurers offering terrorism damage risk is transferred to the GIC. The insurers can pass off only the risk of property damage due to terror attacks to the terror pool, but have to take reinsurance cover for covering people. Sounlike US and UK, India doesn’t have any insurance cover against terrorist acts\textsuperscript{21}.

In the aftermath of the Mumbai terror strikes, insurers are set to expand the terror insurance pool, set up nine years ago, from the current level of Rs 750 crore, and improved products are bound to hit the market, even as there is no claim on this account. IRDA Chairman J Hari Narayan said: The companies are coming out with products that have terror cover. The nine-year-old terrorism pool, with 12 public and private sector insurance companies contributing, provide terrorism insurance cover in standard fire insurance policy and the premium collected by them is pooled. These companies withdraw amounts in the case of claims against terror attacks. The recent terror attacks may run into several hundred crores, even though there is no official word on this\textsuperscript{22}.

The terrorism risk pool, managed by the state-run General Insurance Corp of India, ensures that the bottom-lines of insurance companies do not take a hit when claims are made following such attacks. Narayan said the watchdog was examining a host of issues such as rationalization of insurance intermediaries, permitting outsourcing of non-core activities, new distribution modes like e-sales and payment of premium with re-charge coupons. He stated, adding these will give more flexibility and a choice of option for general insurance products\textsuperscript{23}.

At the same time, a data warehouse will be in place by January with IRDA to help industry improve its understanding of market and analyze trends. This, in turn, will help in improving the quality of products\textsuperscript{24}.

Mr. Pranab Mukherjee present President of India when he was Finance Minister said at onejoint press conference, “Whatever the government thinks is necessary to protect its citizens, the government will do it.” He underlined the need for a global response to

\textsuperscript{20} Terrorism insurance pool set to expand, ENS Economic Bureau.
\textsuperscript{21} Terrorist-attacked hotels may face liability claims, Nov 27\textsuperscript{th} 2008, by Iyans.
\textsuperscript{22} Banking & Finance, Terror insurance pool set to expand.
\textsuperscript{23} India’s terror insurance pool set to jump: Regulator, Dec 3\textsuperscript{rd} 2008, by Iyans.
\textsuperscript{24} ibid.
terrorism which he termed “the biggest threat to world peace in the post-Cold War world.”  

In fact, after the 1993 serial blasts, all general insurance companies came together and decided to raise a common kitty to offset losses due to increase in the number of terrorist acts across the country that destroyed crores of rupees worth of property. “The common terrorism pool today has over Rs 1,000 crore and is set to touch Rs 2,000 crore in a few years, which shows that people do anticipate a terror attack and are not willing to take any chances,” an insurance official said. 

Insurance firms say that new policy holders are becoming increasingly aware of the terrorism cover and insist that this clause be added while they take the fire insurance cover. While public sector insurance firms say this cover has added value to their portfolio, some private sector firms say they have now begun giving an inbuilt terrorism cover. The terrorism policy is only an add-on cover which can be taken with the fire insurance policy cover. Insurers say care should be taken while going for terrorism cover. If a company is giving fire insurance cover for a small premium, the policy holder should check whether the terrorism cover is added. The terrorism cover cannot be added once the policy has been taken. It should be done during the inception. Apart from industries, temples, mosques, gurdwaras, churches and various public and private trusts have also joined the fray. The insurance cover is given only if preventive measures are adopted by the establishments. To avail the facility, they must secure fire and engineering insurance cover, possess property, secure a rider policy (when damages may result from mischievous acts which cannot be classified as a terrorist act) where persons involved in the act are traceable. A rider policy is a must because many people have the tendency to seek money by destroying their own property.

However, commercial property terrorism insurance seems widely available at rates which policyholders accept it as reasonable, but certain types of policyholders may have more difficulty obtaining the coverage amounts they need at prices they view as acceptable. These policyholders are typically owners of high-value properties in urban areas where there is a high concentration of large buildings that are seen as potential terrorism targets. Some

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26. People rush to add terrorism cover to insurance policies, July 12th 2008, Viju B, TNN  
27. ibid.  
28. ibid.  
29. ibid.  
30. ibid.
insurers remain concerned about their exposure to terrorism losses and their efforts to minimize potential losses appear to be the primary reason upon which some policyholders are facing challenges in obtaining coverage.\footnote{31}{Terrorism Risk and Insurance, Sep 2008, part: Recent Development}

**International Scenario:** Prior to September 11, 2001, insurers provided terrorism coverage to their commercial insurance customers essentially free of charge because the chance of property damage from terrorist acts was considered remote. After September 11, insurers began to reassess the risk. However, the United States is not the first country to establish a terrorism insurance program. Some countries created programs to cover terrorism after September 11 or earlier, following a terrorist attack on their own soil. These are examples of other countries terrorism insurance program.\footnote{32}{Terrorism Risk and Insurance, Sep 2008, part: Special terrorism insurance programs in other countries.}

**Australia:** Legislation was passed in 2003, under which terrorism exclusions in commercial policies are nullified once the government has declared that a terrorist incident has occurred. The legislation also created a reinsurance pool to cover insurance company losses from property, business interruption and third-party liability coverages, subject to a certain insurance company deductible, about 4 percent of property insurance premium. Insurers pay premiums into the pool which is back-stopped by the government. The program covers chemical and biological attacks but not nuclear attacks.

**Austria:** A terrorism pool has been in operation in Austria since January 2004. The pool provides reinsurance protection against property damage and business interruption up to a certain limit. Insurers issue a separate terrorism policy and then transfer or “cede” the business to the pool. Participation in the pool is voluntary but almost all insurers belong.

**Belgium:** Under requirements that took effect in May 2008, all insurers must offer coverage for terrorism under most of the policies they issue, with the exception of coverage for certain kinds of risks such as nuclear facilities and mass transportation mechanisms such as trains, airplanes and ships. Insurers are not required to offer stand-alone policies for terrorism. The law creates a terrorism pool with total limits of 1 billion euros, divided into three tiers: direct market, first tier 300 million euros; reinsurance, second tier 400 million euros; and the Belgian government, upper tier, $300,000.

**France:** Under a law passed in 1986, terrorism must be covered. Since 2002,
terrorism has been covered by a reinsurance pool to which terrorism risk above a certain retention level is transferred. Insurers pay premiums to the pool which are divided up among the participants in each of the four different layers of risk with the government-owned Caisse Central de Reassurance (CCR) receiving 10 percent of premiums for providing the top layer of unlimited coverage. The government pays for all terrorist claims that exceed a specific amount. Premiums are set according to the insured amount, not the riskiness of the location.

**Germany:** Private insurers cede commercial insurance coverage written above a certain limit to a pool. The pool, in turn, cedes all its risk to other insurance companies, which act as reinsurers. The ultimate layer of protection, for which insurers pay reinsurance premiums, is provided by the government. The program was extended for two years at the end of 2007 and after 2009 will probably be renewed again but for a lower amount, Germany’s Finance Minister said in making the announcement of the extension. The government pays claims above an aggregate amount.

**Netherlands:** A terrorism reinsurance company was created to reinsure its member companies who retain a percentage of the risk. Coverage is limited per member and in the aggregate. Life and property/casualty insurers participate in the pool, as well as health insurers.

**Spain:** Beginning in 1941, Spain has had a government-sponsored but privately managed pool which provides coverage against injury, property damage and business interruption due to catastrophes, natural and man-made. Personal lines as well as commercial are covered. Coverage for extraordinary risks is mandatory. The original need for terrorist coverage stemmed from acts of violence carried out by the Basque separatist movement, which has been active in Spain for many decades. The 2004 Islamic terrorist bomb attacks in Madrid exacerbated the risk. Private insurers may provide catastrophe coverage but they are still required to make payments to the pool, which is backed by an unlimited guarantee from the government.

**Switzerland:** Beginning in 2003, insurers can cede all property risk insured for a sum above a certain amount to a reinsurance facility.

**United Kingdom:** The government formed a mutual reinsurance pool for terrorist coverage in 1993, following acts of terrorism by the Irish Republican Army. Insurance companies pay premiums at rates set by the pool. There are two geographic zones, one for major cities, with an adjustment for a "target risk," and the other
for the remainder of the country. The primary insurer pays the entire claim for terrorist damage but is reimbursed by the pool for losses in excess of a certain amount per event and per year. This is based on its share of the total market. The maximum industry retention increases annually per event and per year. Following the WorldTradeCenter disaster, coverage was extended to cover all risks, except war, including nuclear and biological contamination, aircraft impact and flooding, if caused by terrorist attacks. The government acts as the reinsurer of last resort, guaranteeing payments above the industry retention.

**Conclusion:** From an insurance viewpoint, terrorism risk is very different from the kind of risks typically insured. To be readily insurable, risks have to have certain characteristics:

The risk must be measurable. Insurers must be able to determine the possible or probable number of events (frequency) likely to result in claims and the maximum size or cost (severity) of these events. A large number of people or businesses must be exposed to the risk of loss but only a few must actually experience one so that the premiums of those that do not file claims can fund the losses of those who do. Losses must be random as regards time, location and magnitude.

But acts of terrorism are intentional, and it doesn't meet these characteristics. In addition, no one knows what the worst case scenario might be. There have been very few terrorist attacks, so there is little data on which to base estimates of future losses, either in terms of frequency, the number of attacks per year, or the size of the losses, known in insurance jargon as severity. Terrorism losses are also likely to be concentrated geographically, since terrorism is usually targeted to produce a significant economic or psychological impact. This leads to a situation known in the insurance industry as adverse selection, where only the people most at risk purchase coverage, the same people who are likely to file claims. Moreover, terrorism losses are never random. They are carefully planned and often coordinated.

While considering all these facts, we can realize the terrorism risks do not have any of these certain characteristics to be readily insurable. But it should be insured since; it damaged the people's life and property. But on the other hand, the insurance companies and insurer should be taken into consideration. An effective way to estimate the risk should be found.

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33. Terrorism Risk and Insurance, Sep 2008, part: Special terrorism insurance programs in other countries.
34. Terrorism Risk and Insurance, Sep 2008, part: Background
35. ibid.
For example, the police forces of different countries can play an important role at this regard. If the police forces in a certain country are well-equipped to tackle terror attacks, especially which is sudden, premeditated and meticulously planned; if they have sufficient weapon training; if they profit by efficient intelligent service, the risk of terror attack will decrease. Here the insurance companies trend to insure the terror attack's risk with less premium. However the police cannot stand up to terrorists who utilize the latest technologies in weaponry, from chemical to possibly biological and nuclear while it is ill-equipped at time comes to seeing terror in the eye, or worse seeing itself at that.

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