14 November 2014

Mr Jerome Davidson
Manager, Insurance and Superannuation Unit
The Treasury
Langton Crescent
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And by email: Jerome.davidson@treasury.gov.au

REVIEW OF THE TERRORISM INSURANCE ACT 2003

Dear Mr Davidson

Thank you for the opportunity to contribute to the triennial review of the *Terrorism Insurance Act 2003*, which includes the Australian Reinsurance Pool Corporation (ARPC) and terrorism insurance scheme, and is due to report to the Treasurer, the Hon Joe Hockey MP, by 23 January 2015. We have reviewed the Terms of Reference which focus on critical scheme issues such as market failure, ownership models, pricing and coverage.

The Act (and scheme) provides an important function, and we strongly support it.

We represent Australia's major owners, managers and developers of shopping centres, which include assets across CBD, metropolitan, regional and rural areas. As a snapshot, of our 24 member companies, our five largest members have $67 billion in shopping centre assets under management, covering 28,000 retailers and generating $49 billion in retail sales (and, thus, significant employment, economic and taxation benefits). The insurance of such assets and minimisation of business disruption, against declared acts of terrorism, is obviously a critical issue for financiers, investors, the community and economy. In addition, the Corporations Act requires our members to properly manage risk.

Our members have been covered by the terrorism insurance scheme since its commencement in 2003, and therefore have made substantial contributions to the pool of reserved funds through the tiered (2%: 4%: 12%) levies on their insurance premiums. Through pre-funding of the scheme across a ten-year period, our members have continued to help address the continued market failure and reduce the risk to the taxpayer.

While we provide detailed comments on the Terms of Reference on the following pages, this submission raises the following critical points:

Firstly, we believe that 'market failure' still exists and a domestic private terrorism insurance market has not developed. This was the case even before the raising of the *National Terrorism Public Alert System* from "medium" ('terrorist attack could occur') to "high" ('terrorist attack is likely') on 12 September 2014, as announced by the Prime Minister, the Hon Tony Abbott MP.

Secondly, we believe the future form of the scheme, and participation in the scheme, needs to be properly considered with a potential for change. This includes both structural and detailed issues such as the suggested consideration of a US-style 'post-funding' scheme, a return of reserved funds to current and past contributors (particularly in light of the dividends, now "fees", provided to the Government under the scheme), the ability for shopping centres to opt-in or opt-out (like the US scheme), and pricing relief through a refined (and possibly expanded) tiered structure and rate reductions.

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We are pleased to provide the following comments, which align with the Terms of Reference.

1. CONTINUATION OF THE SCHEME

Support for the scheme

We support the objective of the Act, including the ARPC and terrorism insurance scheme, since it began operations on 1 July 2003 in the wake of the '9/11' terrorist attacks in the US, as a temporary measure to address a market failure to ensure that commercial property has access to terrorism insurance on reasonable terms, and to minimise associated wider negative economic impacts.

We believe the market failure which was the original catalyst of the scheme still exists, and that a domestic private terrorism insurance market has not developed.

This market failure remains where the provision of insurance from the private reinsurance market is still not available to our members at a reasonable price or on reasonable terms. This is on the basis that the market cannot sufficiently model risk exposure, predict, price or balance terrorism risk and, therefore, individual insurers cannot access reinsurance cover for this risk.

For this reason, we believe the terrorism insurance scheme should continue (subject to our comments in the following sections).

National Commission of Audit

In light of the above, we question the National Commission of Audit's recommendations to abolish the ARPC, including the specific note: "with continued recovery in terrorism insurance markets, there is scope for a gradual Commonwealth exit over the coming years". We are not aware of such a recovery in terrorism insurance markets, let alone a 'continued' recovery.

While we acknowledge and support the 'Principles of Good Government' outlined in the Commission's report, which formed the basis of their recommendation, we do not believe these were properly analysed or considered in relation to the ARPC or the terrorism insurance scheme.

The Principles include reducing the role of government where: (1) the activities are outside core responsibilities; (2) the private sector is better placed to deliver the service; and (3) governments should not and cannot eliminate or insure every risk to the community. In relation to the second principle noted above, we do not believe that the private sector is currently better placed to deliver terrorism insurance, evidenced by the lack of a private market which is priced on reasonable terms.

National Terrorism Public Alert System

The current market failure was present even before the raising of the *National Terrorism Public Alert System* from "medium" ('terrorist attack could occur') to "high" ('terrorist attack is likely') on 12 September 2014, following advice from relevant security agencies.

The 12 September announcement marked the first time the public alert has increased from "medium" since it was first introduced in 2003 (and since the terrorism insurance scheme was introduced).

2. *OWNERSHIP/ALTERNATE MODELS FOR THE ARPC*

The basis for our comments on potential alternate ownership models for the ARPC is our strong view that the current and past contributors to the scheme, particularly to the pool of reserved funds, should be recognised as the owners of the scheme; like a mutual insurance company.

We therefore believe contributors should be entitled to receive income generated from the pool of reserved funds (and retained earnings), or a return of excess funds, particularly in light of the dividends (which has now been replaced with a "fee" under the May 2014 Federal Budget) provided to the Government for its $10 billion guarantee which will total $450 million across the next four years.

US post-funding model should be investigated

While we support the continuation of the scheme, we strongly believe that consideration needs to be given to the future structure of the scheme.

This consideration needs to extend to how the scheme can be designed to better facilitate a domestic private market and ultimately an 'exit strategy' by the Commonwealth, which we support. We acknowledge this is a longer-term objective.

We believe the US-style 'post-funding' model (with no or a minimal element of pre-funding) should be considered, where funds are raised as needed (ie. following a declared terrorism incident), and where the contributions (essentially a maintenance or 'membership' payment) are set at a lower rate, but there is a higher premium rate applying in the event of a declared terrorist incident to be paid by all members who are part of the scheme, so long as there is a mechanism to ensure all parties contribute.

A post-funding model could, for instance, be transitioned at a future time, whereby current funds are ring-fenced for past and current contributors.

A principal reason for suggesting this approach is that, while a pre-funding model was obviously appropriate in establishing the scheme, a transition to a post-funding model has the benefit of leveraging off an existing reserve of accumulated funds (possibly in the form of a hybrid scheme). In this regard, the reserved pool of funds available for claims is now well in excess of the original $300 million target (now $535 million).

The post-funding approach would also have the advantage of lowering the cost of insurance premiums for past and current contributors paid in the pre-funding model, while still maintaining access to insurance.

We believe sound funding for the scheme, and equity, could also be maintained. Adequate and timely reimbursement to insured contributors could also be facilitated in the event of a declared terrorism incident. Further, maintenance and administration costs for Government could be reduced under this approach. The Government's current level of risk exposure and indemnity could also be maintained, or capped.

We believe that consideration could also be given to the potential raising of ad-hoc levies for the scheme such as occurred in 2011 for the then flood-affected regions of Australia.

The ability to opt-out

In addition to the above, we believe consideration should be given to enabling insureds to opt-out of the scheme, similar to (we understand) US scheme operates. Under the current scheme, if an insurer joins the scheme, the insured cannot opt-out. This is problematic given (we understand) the vast majority of Australian insurers participate in the scheme.

The ability to opt-out would have a benefit of giving a shopping centre owner the ability to not seek terrorism insurance of certain assets if they deem them to be of low risk.

Payments to Government

We are concerned with the payments (through the previous dividends, now fees) to the Government from the scheme which, we understand are paid partly through the investment income generated from past and current contributors, the pool of reserved funds, and retained earnings.

Central to this concern is the stripping of funds from the scheme which results in pressure to maintain the current contribution rates and increases the risk for commercial property owners.

Further, while the Government sees it as appropriate to generate a dividend / fee for its $10 billion guarantee, a similar benefit has not been provided to other contributors to the pool of reserved funds, including past and current contributors.

According to the *ARPC Annual Report 2013-14*, these dividends now total $325 million as a reimbursement for the provision of the $10 billion Commonwealth guarantee. As also noted in the *ARPC's Market Update (May 2014)*, following the Federal Budget, the ARPC will "continue to pay the government a total of $450 million in fees and dividends over the next four years". The details of this new "fee" arrangement are described in Budget Paper No. 2 (Part 1).

The payment of dividends was recommended initially in the 2012 review report, where it was noted that "the Commonwealth has to date not received any form of compensation" for its $10 billion guarantee. The 2012 report recommendation was an "initial dividend to the Commonwealth of $400 million, to be spread over four years, with the first payment to be made in January 2013".

We also note that, in any case, the Minister has powers (under section 38 of the Act) to increase premiums to recoup losses, rebuild the pool of funds, and repay the Commonwealth's indemnity in the event that the indemnity is called on following a declared terrorism incident.

Return of funds (or excess funds) to contributors

A potential change in ownership or model for the scheme, and the continuation of dividend / fee payments to the Government, raises a number of issues.

Firstly, we would be concerned if any changed ownership model of the scheme increased the risk or jeopardised the ability of commercial property owners to obtain terrorism insurance on reasonable terms.

Secondly, as we noted above, we strongly believe that the current and past contributors (the insureds) to the scheme, particularly to the pool of reserved funds, should be recognised as the owners of the scheme.

Any future model should recognise this, particularly in the event of a transfer or wind up of the scheme (or even in the event of any form of an initial public offering or IPO) as part of a Commonwealth 'exit strategy'. The current pool of reserved funds, and the investment income from those funds, should not be available for the benefit of other parties, including non-contributors.

Given the reserved pool of funds for claims is well in excess of the original $300 million target, and now stands at $535 million (*ARPC Annual Report 2013-14*), we strongly believe consideration and clarification should also be given to the return of funds (or excess or surplus funds) to past and current contributors. The erosion of otherwise available funds, through the dividends and fees to Government, is a relevant basis for our views in this regard.

We are particularly concerned that current contributions are being used to improve the ARPC's investment income which, in turn, is being used to provide fees back to the Government.

3. PRICING RELIEF / PAYMENTS TO GOVERNMENT

We strongly believe pricing relief should be considered through the current structure of tiered rates and, possibly, the creation of additional rates that better reflect terrorism activity risk in different sub-locations.

The current rates have remained unchanged since the scheme commenced in 2003, which ranges from (as a proxy for terrorism activity risk) 2% (rural), 4% (metropolitan) to 12% (major CBDs) on the underlying insurance premiums for commercial property and business interruption.

We believe rate relief should be considered for the following major reasons.

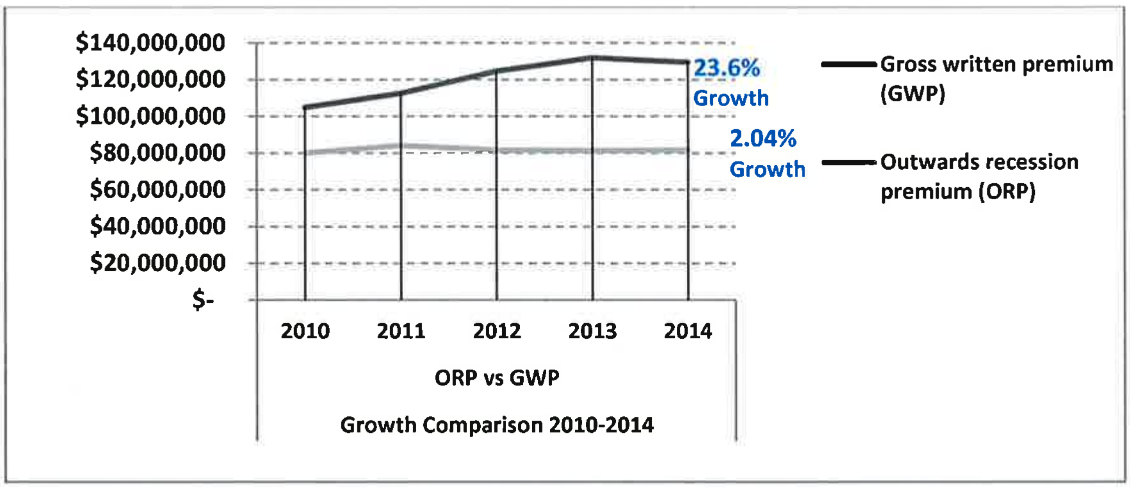
Are the current rates disproportionately over-priced?

In the absence of a domestic private terrorism insurance market, it is difficult to determine whether current pricing is at an appropriate 'market' rate.

However, our interpretation of data such as the 'Financial Highlights' in the *ARPC Market Update (5 November 2014)* suggests that growth of the market price for the ARPC's *outwards retrocession premium*, where the ARPC purchases pool reinsurance cover from Australian and global markets, has significantly outpaced the growth of *gross written premiums* (i.e. premiums collected) from 2010-2014.

The cost for the ARPC to purchase reinsurance appears to have remained stable (at around $80 million per annum), with an <u>increase of 2.04%</u> from 2010 ($80.098 million) to 2014 ($81.728 million); with the current reinsurance amount being $3.2 billion. Similarly, *retrocession commission income* remained fairly stable. However, the gross written premium has <u>increased by 23.6% over the same period</u> (going from $104.885 million to $129.642 million).

The below chart illustrates what we understand could be disproportionate pricing.



One interpretation of this data could be that the premium rates have been significantly higher than market rates and are, therefore, disproportionately over-priced, which could enable some price relief. We would welcome clarification from the ARPC on this issue.

In questioning the disproportionate gap in these datasets, which provides a possible benchmark, we are mindful of the statement in the 2012 Review Report (at page 28) that "based on stakeholder feedback, and in the absence of data and benchmarks for pricing, the Review considers that the ARPC's pricing is adequate".

Collection target exceeded / dividends suggest potential capacity

Rate relief for commercial property owners should be considered given the size and capacity of the scheme (which exceeds the original $300 million target, and now stands at $535 million).

Further, *investment income* has declined over the same period, part of which we understand is due to the dividend / fee payments back to Government. This suggests there could be capacity in the scheme to provide similar relief to other contributors to the scheme, whether through pricing or, as noted above, a return of funds to past and current contributors.

ARPC modelling data could refine location rates

Aside from pricing issues within the current tiered structure, we believe that the current structure could itself be reviewed.

The three tiers (2%, 4%, 12%) might have been appropriate at the time of the scheme's establishment, however there could be an opportunity for more than three categories, through further granularity such as additional locational descriptions and, hence, lower premium rates in certain areas.

Further, the rates should possibly be reviewed more frequently in line with emerging information.

As an example, upon reading the ARPC's literature, we understand that there could be more detailed information which helps the ARPC in managing its risk. This includes the 3D blast modelling for CBD locations, potential models of terrorism and the increased data analysis capacity.

Aside from this information being used as the basis for a different tiered pricing structure, we also believe this information could be provided to commercial property owners to help them better understand their own risks.

In summary, and drawing on previous sections of this submission, we broadly believe that rate relief should be considered for the following reasons:

- It could help facilitate a private sector terrorism insurance market.
- Current contributions are flowing out of the scheme to the Government through fees, and a similar benefit is not being provided to contributors.
- The current size and capacity of the scheme, including the pool of reserved funds available, is well beyond the initial $300 million target.
- The potential change in ownership structure or model, such as a transition to a post-funding model, could reduce the need for further pre-funding.
- There has been no rate relief since the commencement of the scheme.

- In addition, the annual contributions can be hundreds of thousands of dollars per annum for a particularly company, over and above what their insurance premiums would otherwise be.

4. COVERAGE OF THE SCHEME

We have no comment on the extension of the scheme beyond commercial property, to include apartment buildings, except that to ensure that the current reserve of funds is ring-fenced to past and current contributors. We strongly believe that new asset types, such as apartments, should not benefit from the current pool of reserved funds. However, given a clear trend in mixed-use development, which is often encouraged and articulated in state and territory planning schemes, commercial uses in apartment buildings should be caught by the scheme to ensure a level playing field across the commercial property sector.

We would welcome the opportunity to discuss this submission with The Treasury and ARPC at any convenient time.

As a broader point, we would welcome the opportunity engage with the ARPC as part of its ongoing interaction with stakeholders.

The Shopping Centre Council represents Australia's major owners, managers and developers of shopping centres. Our members are AMP Capital Investors, Brookfield Office Properties, Charter Hall Retail REIT, DEXUS Property Group, Eureka Funds Management, Federation Centres, GPT Group, Ipoh Management Services, ISPT, Jen Retail Properties, JLL, Lend Lease, McConaghy Group, McConaghy Properties, Mirvac, Novion Property Group (formerly Colonial First State Retail Property Trust), Perron Group, Precision Group, QIC, Savills, Scentre Group (formerly the Westfield Group and Westfield Retail Trust) and Stockland.

Please do not hesitate to contact me on anardi@scca.org.au or 02 9033 1930 to discuss this submission.

Yours sincerely,

14.11.14

Angus Nardi
Executive Director

C.c. Dr Christopher Wallace, CEO, ARPC