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MARINE WAR RISK INSURANCE Should the Government be involved?

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THE Joint War Committee of the Lloyd's Market Association has continued to list the Malacca Straits and its associated ports as a war risk area after its last meeting in January. This is despite the fact that the shipping community in the region has made representations to the Committee to reconsider its assessment and despite a report commissioned by the Singapore Maritime Foundation stressing that the Malacca Straits was not a dangerous place.

Thus, there is clearly a gap between objective risk and perceived risk. On the one hand, the objective risk of terrorism in the Malacca Straits may be low as a result of the reduced frequency of piracy attacks in 2005 as compared to 2004. Another reason is the fact that the number of maritime terrorism incidents in relation to the total number of terrorism incidents is less than one percent. Yet, on the other hand, the perceived risk of terrorism in the marine hull insurance market continues to be high. This has impacted on the premiums that ships have to pay while transiting the Malacca Straits, with some estimates putting it at US\$5,000 per trip.

In fact, the marine insurance market has been turbulent after the September 11 incident. There are problems of increased premiums, lack of capacity and difficulties in signing of new coverage. Terrorism and damage caused by chemical and biological means are excluded from ordinary insurance in line with war losses and damage due to radioactivity. The number of excluded areas for re-insurance has increased. Additional premiums and reporting are required in advance of entrance. The risk is still perceived to be high in the market, although the objective risk may have been reduced as a consequence of the international "war against terrorism" and the various security initiatives implemented. Significant terror losses are now considered "real" hazards, and no longer unrealistic events.

In such situations of perceived high war risk, the market cannot take the entire risk alone to cover a worst case scenario. The government needs to step in. Governmental arrangements are needed in extreme situations, such as when:

- (1) war risk clubs experience a significant loss that is not re-insured;
- (2) the underwriters are not able to cover claims;
- (3) the underwriter market collapses; and
- (4) re-insurance premiums get extremely high over long periods of time.

As the government has overall responsibility to protect people against terror attacks with consequences for society, they should also therefore contribute to solutions for compensation of losses resulting from such incidents. There are four main arguments for this:

- (1) the government may have a responsibility because it may be involved in processes and operations resulting in damage and losses to vessels;
- (2) the government has a significant interest in the national fleet;
- (3) it is important that aims of terror attacks do not succeed so as to maintain an open global business community. Re-insurance may then require governmental actions to maintain the business environment; and
- (4) the government has the overall responsibility to protect people against terror attacks, with consequences for the society, and should therefore contribute to solutions for compensation of losses resulting from such incidents.

How Government can be involved

But how will such governmental arrangements work?

A governmental arrangement will be a risk-taking arrangement, limited to the low frequency and high consequence events. Initially, a fund may be set up over a certain level and further financed by premiums paid by war risk clubs. This arrangement will have similarities with the present role of the underwriters. An arrangement in competition with present market underwriters is not feasible, but this may be an option for additional coverage not provided by the underwriters today. Moreover, such an arrangement may be introduced if the re-insurance market disappears. A premium may be paid by a war risk club based on long term risk estimates. Alternative structures for such an arrangement are coverage for claims above a defined level or coverage for claims related to pre-defined hazards and losses.

Several models are possible to solve this.

The 'easy' solution is simply to exclude losses related to terrorism from ordinary insurance and let the market decide. Pool arrangements to distribute risk efficiently within the insurance and underwriters market are another alternative. Potential models for governmental arrangements with respect to war risk include the following:

- (1) A new pool arrangement is established to cover terror risks. Obligatory fees from defined insurance categories finance the pool. The government guarantees for risks above a defined level so that the commercial insurance market does not take on risk, but administers the pool arrangement;
- (2) A layered system is established. The insurance market takes on risk up to a defined level. A pool arrangement is established for an intermediate risk level. Re-insurers and underwriters in the market cover some of the risk. Government will guarantee or act as a re-insurer for the risk that cannot be covered in the commercial market;

- (3) The insurance companies take on the terror risk with re-insurance and guarantees from the government for the risk that cannot be covered by the ordinary insurance market.

To carry out such arrangements, a frequency-consequence curve is required. This is a curve that plots the frequency of incidences like piracy and hijacking versus the consequences in terms of monetary losses as a result of the incident. It is also a system to assess war risk in order to quantify expected yearly costs for risk not re-insured, risk taken through retention, and risk related to periods with extremely high re-insurance rates. Historical data on incidents is used to quantify risk related to events occurring “regularly”, that is, sabotage, piracy, war losses, minor terror attacks, hijackings, and the like. Data sources and databases need to be built up to quantify levels of risk related to these hazards.

The risk picture has to be completed by various terrorist scenarios. The scenarios should be prioritised according to intention and capability of terror organisations, resourced required for the attack, likely consequences and ship vulnerability.

In conclusion, although the objective risk of terrorism in the Malacca Straits is low, the perceived risk of terrorism in the marine hull insurance market continues to be high. While additional premiums may be affordable at present, with some estimates putting it at US\$5,000 per trip through the Malacca Straits, we cannot assume that it would remain so.

To cushion the possibility of higher insurance rates, governmental arrangements are required and three potential models for such arrangements have been highlighted. The downside is that such governmental arrangements will have to be predicated on a frequency-consequence curve to assess war risk in order to quantify expected yearly costs for various types of risk. Although a method to derive such curves has been described, the expertise to derive such frequency-consequence curves resides in the insurance industry.

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