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No. 110 2002–03

Terrorism Insurance Bill 2002

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Terrorism Insurance Bill 2002

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Terrorism Insurance Bill 2002

Date Introduced: 12 December 2002

House: House of Representatives

Portfolio: Treasury

Commencement: Royal Assent

Purpose

The purpose of the Bill is to set up the framework for a terrorism insurance scheme and to establish a statutory authority, called the Australian Reinsurance Pool Corporation, to manage the scheme.

Background

The events of 11 September 2001 in the United States, had a major impact on the insurance industry and in particular saw the withdrawal of cover for terrorism risk by insurance and reinsurance¹ companies. According to the Reinsurance Association of America (RAA), the expected insurance losses from the 11 September events were the largest ever recorded and were estimated to be between \$35 and \$75 billion with 60 to 80 percent of the ultimate losses lying with reinsurers.²

The Treasurer in his Press Release of 20 December 2001 acknowledged this problem stating:

Action may be required as a result of advice from international reinsurers that cover for terrorism will be removed on all new treaty reinsurance from 1 January 2002 and that terrorist cover on facultative reinsurance has been withdrawn for new risks and is being withdrawn as existing policies come up for renewal.

The Treasurer stated that while there would be consultations with the relevant industries to determine a response to this problem he also cautioned:

It cannot be assumed that the outcome of the consultation process will involve the Commonwealth Government providing indemnities or financial assurances to the insurance industry, or particular sectors of the economy. Since insurance is a

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commercial matter, obviously it will be necessary to engage the private sector in risk allocation and pricing indemnities.³

Pressure for government intervention from the insurance, property and banking industries became stronger in early 2002 and there were calls on the Government to commit itself to providing a financial safety net by being the insurer of last resort in claims arising from terrorist acts.⁴

Media reports were suggesting that large enterprises were finding it not only impossible to get terrorism insurance, but that this in turn was jeopardising loan contracts and throwing major projects into doubt.⁵

According to a survey conducted by the Association of Risk and Insurance Managers of Australasia (ARIMA), of its 500 members in early 2001, more than 40 per cent of companies had had terrorism excluded from policies renewed since September 11, and of those yet to renew, 64 per cent had been told they also would not get cover.

Bruce Ferguson, president of ARIMA was quoted as saying:

The lack of cover puts financing for key projects at risk [...] It means in the case of loans for major projects, people are technically in default for these sorts of exposures. In the worst-case scenario, it will stop investment in major projects [...] Organisations need a financial safety net, and the only logical means of providing it is through a government-sponsored fund.⁶

In May 2002, the Government announced that it would offer remainder insurance for losses above the cover available from individual insurers, possibly after a pooling arrangement. However the Treasurer noted that any intervention would need to be consistent with:

- the need to maintain, to the greatest extent possible, private sector involvement; ensuring that risk transferred to the Commonwealth is appropriately priced
- allowing the re-emergence of the commercial markets for terrorism risk cover, and
- global solutions.⁷

Overseas comparisons

Calls for a government sponsored scheme were also accompanied by reference to several overseas examples of where foreign governments have provided reinsurance when the market was unable to do so.⁸

In the UK, a pool reinsurance company, Pool Re, was established in 1993 to ensure the continued availability of insurance cover for damage and loss caused by terrorist actions, which had become largely unavailable after a spate of IRA attacks.⁹

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In France, since December 2001, the state-owned Caisse Centrale de Reassurance under government guarantee, covers physical and property damages caused by terrorism attacks above an annual 1.5 billion euros ceiling. Under this amount, the insurance and reinsurance markets cover the risks. Other countries that also have special mechanisms to deal with terrorism risks include Spain, South Africa and Israel.¹⁰

The United States Congress, following the 11 September attacks, also considered a scheme to address the risk of a shrinkage of affordable insurance. Congress finally passed the US Federal Terrorism Insurance Act in November 2002 which makes it compulsory for insurers to offer terrorism coverage. However organisations then have an option whether to accept the coverage - for an additional premium.¹¹

Australian scheme

On 25 October 2002¹², the Treasurer announced the detail of a scheme for replacement terrorism insurance. The main features of that scheme are:

- It would cover commercial property and infrastructure facilities, and include associated business interruption and public liability.
- It would compel insurance companies to provide cover for terrorism risk on all policies in all classes of insurance included under the Scheme. Insurance companies would be able, but not obliged, to reinsure their terrorism risk exposure with the proposed scheme.
- It would provide a pool of funds (initially planned to accumulate to about \$300 million) funded by premiums.
- The level of insurance cover and excess for terrorism risks would match the level of coverage and excess otherwise provided under the policy.
- In the event of a terrorist incident, the insurance industry would bear the first \$10 million of claims, subject to an individual company exposure limit of \$1 million per annum. After that the Government scheme would operate to pay claims. The Government scheme would pay claims from 3 tiers:
 - The pools funds up to the limit of \$300 million
 - Up to \$1 billion in excess of the pool funds from a commercial loan facility guaranteed by the Federal government, then
 - Up to \$9 billion in excess of the commercial loan facility from 'reinsurance' (in effect a government indemnity) provided by the Federal government.
- To manage the scheme the Government would establish a new statutory authority called the Australian Reinsurance Pool Corporation.

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- The scheme would cover damage caused by terrorist activity, including causes such as fire, flood, explosion, aircraft impact, biological and chemical, but not nuclear causes.
- A Commonwealth minister or senior official would make a declaration as to whether an event falls within the scheme in order to facilitate rapid claims settlement and avoid legal disputes over coverage.
- In the event of a terrorism claim which depletes the fund, rates would be reviewed in order to repay the commercial loan and the reinsurance facility, and to replenish the pool funds over a number of years.
- The Australian Reinsurance Pool Corporation under direction from the Treasurer would set premiums payable by insurers for the reinsurance contracts. Premiums would depend on the risk of insured properties and facilities, and would be expected to cost from around 2 per cent of underlying base premium, with surcharges of 10 per cent and 2 per cent applying to properties located in capital city CBDs and other urban areas respectively.
- The Scheme would operate from 1 July 2003, subject to passage of the relevant legislation.¹³

The Terrorism Insurance Bill 2002 proposes to implement this scheme.

Reaction of interest groups

Media reports suggest the Government's scheme has the support of the banking and real estate industries which had claimed that insurers' unwillingness to cover terrorist attacks was stopping commercial development.

Property Council of Australia chief executive Peter Verwer was reported as saying that developers could now proceed with confidence.

The financial community was threatening to withdraw funds from new projects and to finance sales. This ends all of the uncertainty.¹⁴

The Treasurer's announcement was also welcomed by the Insurance Council of Australia (ICA).¹⁵ ICA Executive Director Alan Mason stated:

Terrorism insurance has required a Federal resolution since the international reinsurance market withdrew from providing terrorism cover. [...]

The Government's pool proposal will provide cover to business that is currently unavailable. By spreading the cost over the entire insuring community it will make cover more affordable and widely available.

ICA did however state that it would be seeking further clarification in relation to the potential exposure to terrorism risk not covered by the scheme, particularly the

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requirement that insurers will bear the first \$1 million per insurer or \$10 million per incident.¹⁶

The scheme has attracted some criticism from industry and risk management bodies, in regard to the compulsory nature of the scheme.¹⁷ Their criticism is that businesses that neither need nor want terrorism insurance will not have a choice if they wish to have property, business interruption and/or public liability cover. While the Explanatory Memorandum states that rates will vary according to risk factors, many businesses with virtually no risk of terrorist attack will nonetheless have to pay a levy to subsidise high risk businesses and properties. ARIMA argues that the effect of a compulsory levy is likely to be that those entities which do not want the cover will self insure those risks, or insure them offshore, or use an offshore captive insurance company for those risks. Consequently they will not be participating in insurance arrangements in Australia which will attract the levy.¹⁸

The Government on the other hand has defended the compulsory nature of the scheme saying it is essential to allow accumulation of a credible funds pool within a reasonable period.

Universal terrorism insurance is designed to avoid problems of undiversified risks (for example, insuring only high risk buildings) and uncertainty as to who will be eligible for compensation in the event of a terrorist act.¹⁹

Main Provisions

Definitions (clauses 3-5)

Clause 5 defines a 'terrorist act' as an act or threat that:

- causes death or serious harm to a person, or
- causes serious damage to property, or
- endangers another's life or creates a serious risk to public health or safety, or
- seriously interferes with, disrupts or destroys an electronic system such as a telecommunications system, financial system, transport system or essential public utility, and
- is done or made with the intention of advancing a political, religious or ideological cause and with the intention of coercing or intimidating a Commonwealth, State or Territory Government, a foreign country, or the general public in either Australia or a foreign country.

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'Advocacy, protest, dissent or industrial action' are excluded from the definition of a 'terrorist act', where such actions are not intended to cause serious physical harm or death, endangerment of life, or serious risk to the health or safety of the public.

The definition of 'terrorist act' in the Bill is drafted in almost identical terms to the definition in section 100.1 of the Criminal Code—Schedule to the *Criminal Code Act 1995*. For a discussion of that definition the reader is referred to the Digest (Bills Digest no. 126, 2000-01) for the Security Legislation Amendment (Terrorism) Bill 2002 [No. 2].

Insurance for terrorism risks (clauses 6-8)

Clauses 6-8 set out the framework for the new insurance cover for terrorism risks. In simple terms **clause 6** deals with obligations on the Minister in declaring whether a particular terrorist act falls within the scheme, **clause 7** defines what types of insurance contracts will be covered by the scheme and **clause 8** deems that terrorism risk cover will automatically be included in those contracts.

Clause 6 sets out the circumstances in which the Minister (or delegate)²⁰ must declare that an act constitutes a terrorist incident for the purposes of this Act. Before making such a declaration the Minister must seek advice from the Attorney General (**subclause 6(1)**). The declaration, once published in the *Gazette*, cannot be revoked (**subclause 6(5)**).

To be declared a terrorist incident, the event must have happened in Australia (**subclause 6(1)**) and the Minister must be satisfied that it is not an act of war (**subclause 6(2)**). If the terrorist act is merely a threat, then it can only be declared a terrorist incident if the Minister is satisfied that the threatened action would have happened in Australia and that the threat has resulted in economic loss to a person (**subclauses 6(3) and (4)**).

The Minister may also declare that insurance companies pay outs in regard to a particular terrorist incident are reduced by a certain percentage (**subclause 6(6)**). In determining whether a reduction percentage is necessary, the Minister would look to whether the incident might exhaust the resources available to the Australian Reinsurance Pool Corporation (**subclause 6(7)**). Following the initial declaration, the reduction percentage can be altered, but may only be made smaller (**subclause 6(8)**).

Clause 7 sets out which insurance contracts are covered by the terrorism insurance scheme. Essentially 'eligible insurance contracts' are contracts that provide insurance cover for loss or damage to tangible property located in Australia, either with or without:

- insurance cover for business interruption losses arising from loss or damage to the property, or
- insurance cover for public liability associated with the property.

Regulations will further specify the types of contracts to be covered by the scheme (**subclauses 7(2) and (3)**) The Explanatory Memorandum sets out that the types of insurance coverage that will be excluded through regulations. These include: insurance for

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buildings or infrastructure owned by State or Commonwealth Governments (but not Government Business Enterprises), domestic policies, insurance for private residential property, marine insurance, aviation insurance, motor vehicle insurance, life insurance, health insurance, private mortgage insurance, medical indemnity insurance, professional indemnity insurance, and reinsurance.²¹

According to the Explanatory Memorandum²² the scheme does not cover workers compensation and compulsory third party insurance, although the opportunity for providers of these classes of insurance to reinsure through the Australian Reinsurance Pool Corporation, will be discussed with the relevant States and Territories.

Subclause 8(1) deems that eligible insurance contracts that are in force on or after 30 June 2003 are taken to provide the same amount of terrorism insurance cover as the contract provides for losses arising from other causes. If the contract provides different amounts payable and different excesses for different events or causes of damage, then the highest of the amounts payable and lowest of excesses applies to the terrorism losses (**subclauses 8(2) and (3)**). The Explanatory Memorandum provides examples of how this would work.²³

In general, the terrorism cover will be subject to the terms of the contract in the same way as other insurance cover provided by the contract (**subclause 8(6)**). However, exclusions or exceptions relating to the cause of a loss or liability are overridden (**subclause 8(5)**).

The Explanatory Memorandum states that deemed terrorism cover does not extend to loss or liability arising from the hazardous properties (including radioactive, toxic or explosive properties) of nuclear fuel, nuclear material or nuclear waste.

Subclause 8(7) is a transitional provision. It provides that for those eligible contracts in force at the start up date of the scheme (ie 30 June 2003), the Australian Reinsurance Pool Corporation is liable to compensate the insurer for any liability that arises solely because of clause 8. If the insurance contract in force at start up time already included some cover for terrorism, then the obligation on the Corporation to compensate would only extend to any extra liability deemed by clause 8.

Australian Reinsurance Pool Corporation (clauses 9-40)

Clause 9 establishes the Australian Reinsurance Pool Corporation (the Corporation).

The functions of the Corporation are to provide:

- insurance cover for eligible terrorism losses, and
- any other functions as prescribed by regulations (**clause 10**). The Explanatory Memorandum provides more detail on what functions might be included in regulations.²⁴

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Clause 11 provides that the Corporation has the power to do all things necessary for the performance of its functions. Powers include being able to charge premiums in respect of contracts of insurance, and charging fees for services (**subclause 11(2)**).

The Corporation is to be a body corporate with perpetual succession and is to consist of the Chair and at least four, but not more than six, other members. (**clause 12**).

Clauses 13-20 deal with appointment of members of the Corporation. Amongst other things:

- Members of the Corporation are to be appointed by the Minister on a part-time basis for a period of up to 4 years (**subclauses 13(1) and (2)**).
- The Minister in making an appointment must be satisfied that the person has suitable qualifications or experience and is of good character (**subclause 13(3)**).
- Members are to hold office according to the terms and conditions set out in the Act and as determined by the Minister (**clause 15**).
- The Minister may appoint a member of the Corporation to act as a Chair when that office is vacant or when the Chair is absent from duty (**clause 14**).
- Members of the Corporation are to be paid according to rates determined by Remuneration Tribunal, or else according to the prescribed remuneration (**clause 17**).
- Members may resign by giving a written resignation to the Minister (**clause 19**).
- The Minister may terminate the appointment of a member of the Corporation for reasons such as bankruptcy, absence from meetings of the Corporation, engagement in paid employment that conflicts with the performance of duties, and unsatisfactory performance (**clause 20**).

Clauses 21-23 set out the requirements regarding meetings and resolutions of the Corporation.

Clauses 24-31 deal with the appointment and duties of a full-time Chief Executive. The Chief Executive is to be appointed by the Corporation to manage its affairs subject to the directions of, and in accordance with policies determined by the Corporation (**clause 25**). The Chief Executive cannot be a member of the Corporation (**subclause 24(3)**) and the appointment may be terminated by the Corporation at any time (**clause 26**).

Clause 32 deals with the appointment of employees of the Corporation and **clause 33** deals with the engagement of consultants.

The Corporation may delegate its powers or functions to the Chief Executive or an employee (**clause 40**).

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Clauses 34-37 deal with the finances of the Corporation. Amongst other things these clauses specify:

- The Corporation's money is to be applied only in payment of expenses and liabilities incurred in performing its functions, and in payment of remuneration and allowances payable under the Act (**subclause 34(1)**).
- Surplus money of the Corporation may be invested in accordance with Division 3 of Part 3 of the *Commonwealth Authorities and Companies Act 1997* (**subclause 34(2)**).
- The Commonwealth guarantees the due payment of money that may become payable by the Corporation to any person other than the Commonwealth up to an amount of \$10 billion (**clause 35**).
- The Corporation is to be exempt from income tax under laws of the Commonwealth (**clause 36**).
- The Consolidated Revenue Fund is to be appropriated for payment of amounts borrowed by the Corporation from the Commonwealth, and payments under section 35 (**clause 37**).

Clause 38 proposes that the Minister may give written directions to the Corporation in relation to the performance of its functions and the exercise of its powers. Amongst other things these directions could:

- require the Corporation to pay money to the Commonwealth
- require the Corporation to enter into contracts to borrow money from the Commonwealth
- require the Corporation to enter into contracts to borrow money from persons other than the Commonwealth (although such a direction may not specify a particular person (**subclause 38(4)**))
- set premiums to be charged for insurance contracts issued by the Corporation, and
- set out the extent to which risk is to be retained by the insured under a contract of reinsurance with the Corporation (**proposed paragraphs 38(2)(a) - 38(2)(e)**).

Directions relating to premiums and retentions by insureds must be published by the Minister (**subclause 38(6)**).

Directions might also be issued by the Minister to require payments to the Commonwealth in the nature of dividends, or payments to allow the Corporation to comply with competitive neutrality principles (**subclause 38(3)**).

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Miscellaneous matters (clauses 41-43)

Clause 41 provides that the Minister is to review the need for the operation of the Act every three years.

Clause 42 provides for the payment of just compensation by the Commonwealth where the operation of the Act would result in the acquisition of property other than on just terms within the meaning of section 51(xxxi) of the Commonwealth Constitution. Where there is disagreement on the amount of compensation, the person may institute proceedings in the Federal Court.

Clause 43 enables the Governor General to make regulations for the purposes of the Act.

Concluding Comments

The need for some form of Government sponsored terrorism insurance scheme appears to have bipartisan support. However it is of note that much of the detail of the scheme regarding the funding, the types of policies, pricing and coverage is still to be finalised by regulation. The Government has defended the lack of detail in the Bill saying that components of the scheme are deliberately flexible, not being set in legislation, in order to encourage the reemergence of the commercial market.²⁵ The Government's insistence that the scheme is to be only temporary is also evident in the requirement in the Bill for three yearly reviews.

However overseas experience might cast some doubt on the temporary aspect of the scheme. As discussed above, several OECD governments have long had schemes in place to cover terrorism risk. Many of those schemes were introduced to deal with a particular set of political events, which had led to a re-evaluation of risks and the reduction of coverage. Often they were thought of as a temporary state response to market failure, in the expectation that with time, the insurance industry's capacity would develop and efficient risk-sharing arrangements would be re-established. The OECD Economic Outlook²⁶, suggests that the fact that many of these schemes have endured beyond their original mandate is an indication that either the market failure was not temporary or that government intervention crowded out private sector responses.

Endnotes

- 1 Insurers take out reinsurance to spread their risk and to protect themselves against catastrophic claims that would otherwise empty their reserves. The notion behind the benefits of reinsurance is the same as that behind insurance itself; namely the law of large numbers implies that the more policies which can be averaged together, the more accurate the expected claim cost is as a predictor of the actual average claim cost, and so insurers that take out

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reinsurance gain efficient risk protection in just the same way individuals do when they take out insurance. It has been suggested that insurance companies shift about a quarter of their risk by taking out their own insurance policies with reinsurance companies, although in the case of public liability and professional indemnity policies that the figure is said to be around 40%. (Source: 'Crunch time, again, for insurance', *Sydney Morning Herald*, 1 May 2002).

- 2 The *OECD Economic Outlook*, June 2002/1 agrees that the losses from this event were the highest ever but put the estimated losses at between \$30 billion and \$58 billion.
- 3 Treasurer 'Government Response to the Withdrawal of Terrorism Insurance', *Press Release*, No. 101, 20 December 2001.
- 4 'Plea to PM to provide terrorism cover', *Australian Financial Review*, 18 April 2002.
- 5 'September 11 takes its toll on terrorism insurance cover?', *Age*, 10 April 2002.
- 6 *ibid.*
- 7 Treasurer, 'Terrorism Insurance', *Press Release*, No. 031, 21 May 2002.
- 8 'Terrorism exclusions should sound alarm', *Australian Financial Review*, 27 March 2002.
- 9 Pool Re functions as a reinsurance company for its (voluntary) members, while the Government provides reinsurance to Pool Re. The first £100 000 lies with primary companies, with Pool Re intervening only above that amount. Losses from underwriting activities are covered by accumulated premia or, if needed, by an additional call on members (limited to 10 per cent of the annual premium). Beyond that, claims are met by the Government. This scheme enables insurers to cover terrorism without the need to restrict the sums insured, but does not encompass third party liability insurance. (Source: *OECD Economic Outlook* June 2002/1, p. 71.)

Shadow Treasure Bob McMullan was reported in the *Financial Review* as suggesting that the Government should consider the UK model as a potential solution for Australia's terrorism insurance drought. *Australian Financial Review* 16 July 2002.

- 10 *OECD Economic Outlook* June 2002/1, p. 71.
- 11 Insurers covering property and casualty losses in the US must now make available coverage for damages resulting from acts of foreign terrorism on US soil for any commercial line of property and casualty insurance covered by the Act. Insurers are required to provide their customers with quotations of costs for the terrorism coverage.

The Act encompasses a wide range of commercial insurance including most lines of financial and professional liability, property, marine, aviation, general liability and motor vehicle liability insurance and surety.

Under the Act coverage cannot 'differ materially' from the terms and limitations applicable to other events under a policy, but interpretations of this may vary. However, there is no restriction on the price an insurer may charge for terrorism coverage.

Source: 'Implications of the new US Federal Terrorism Insurance Act' *Marsh News* December 2002. Located at:

<http://www.marsh.com.au/pdf/MarshNewsDec02.pdf>

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- 12 and perhaps significantly 13 days after the Bali bombings.
- 13 Treasurer, *Press Release: Terrorism Insurance*, 25 October 2002.
- 14 'Terror Levy of 12pc on business' *Weekend Australian*, 26 October 2002.
- 15 ICA, 'Federal Scheme to Provide Terrorism Cover', *Media Release*, 25 October 2002.
- 16 *ibid.*
- 17 ARIMA, Comment on the Terrorism Insurance Bill 2002 (unpublished); Focus (McCullough Robertson lawyers) (www.mccullough.com.au) Also a report in the *Weekend Australian*, 26 October, suggested that a group of 12 companies including Telstra, Shell, Fosters, Alcoa, Rio Tinto, BHP Billiton, Coles Myer, Orica, Amcor and Fluor, united to try and overturn the new scheme, believing they would be forced to subsidise inner-city commercial property owners whose properties were more at risk than their industrial complexes. The report suggested that the surcharge of 10 per cent added to the insurance premiums of inner-city property owners was added as a concession to this group. 'Terror levy of 12 pc on business', *Weekend Australia*, 26 October 2002.
- 18 ARIMA, Comment on the Terrorism Insurance Bill 2002 (unpublished).
- 19 *Explanatory Memorandum*, p. 1.
- 20 The Minister may delegate his powers in relation to declaring a terrorist incident to either the Secretary or a SES officer of the Department of the Treasury (**subclause 6(9)**).
- 21 *Explanatory Memorandum*, p. 19.
- 22 *ibid.*
- 23 *ibid.*, p. 20.
- 24 *ibid.*, p. 22.
- 25 *ibid.*, p. 2.
- 26 June 2002/1.

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