



**The Fifth Biennial MIGA-Georgetown Symposium on
International Political Risk Management: Meeting
the Needs of the Present, Anticipating
the Challenges of the Future**

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**THE CONVERGENCE OF THE TERRORISM
INSURANCE AND POLITICAL RISK INSURANCE
MARKETS FOR EMERGING MARKET RISK**

Why it is necessary and how it will come about

by

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Introduction

This paper addresses terrorism and political violence insurance covering physical loss or damage to property in emerging markets. Surprisingly in the current environment, this is an area of neglect in the insurance industry.

The paper begins by contrasting the fortunes of the investment insurance market since 9/11 (where there has been a decline in demand for traditional equity and lenders political risk insurance (PRI)) with the dramatic growth and success of the stand-alone terrorism insurance market in the same period. The paper notes this separation of the PRI market and the terrorism insurance market, a separation that suits the insurance industry's conventional approach, but fails to give clients with assets in emerging markets the cover that they need.

In calling for an end to this separation and a merger between the terrorism insurance market and the PRI market, the paper advances a four point doctrine concerning terrorism and political violence insurance for emerging market assets. Central to this is the view that in emerging markets the separation of terrorism risk from war risks (as understood by the insurance industry) and political risk is a practical impossibility. Once this point is understood, the implications for traditional property insurers, for the stand-alone terrorism insurance market and the PRI market become clear. Understand emerging market terrorism, and the door is opened to a transformation in insurance industry thinking, one in which terrorism insurance in emerging markets is seen as a specialist PRI product.

The merger is already underway, and the transformation is beginning. However the paper argues that for the process needs to be driven forward by both clients and the PRI underwriters. Specifically the clients need to be more demanding and refuse to accept terrorism insurance for their emerging market assets that contains a conventional war risks exclusion.

On the supply side, PRI insurers need to shift focus. In doing so they have to confront their own prejudices, and those wider taboos in the insurance industry, that have hindered the writing of property damage covers for political violence and war risks. In this regard, the PRI market can take comfort in their own underwriting principles, and in the recent experience of the terrorism insurance market.

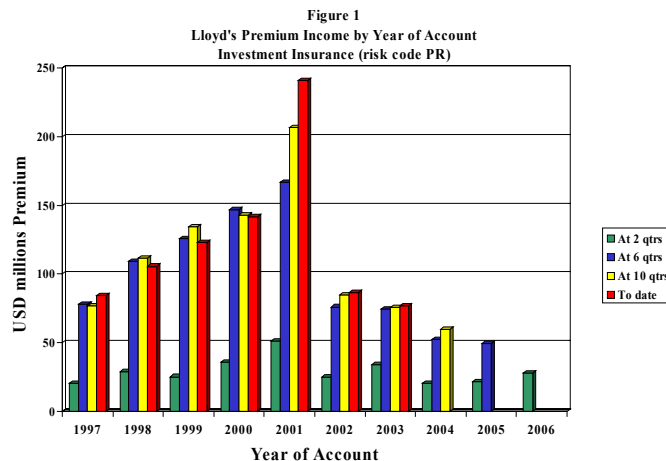
By writing terrorism and political violence in a property insurance form (rather than just in an equity or lenders form) the PRI market will experience a revival in their fortunes. For they will be providing a new policy that is both simple and highly relevant. From this platform, the PRI insurers can then tackle exotic "beyond the fence" terrorism risk, contingent business interruption, threat and abandonment, etc.

However that is for later. This paper is about ensuring that the basics are right. This is necessary as currently, the insurance industry is fundamentally wrong in its approach to straightforward, property-based terrorism and political violence covers in emerging markets. Only the PRI market can put this right.

Stagnation of traditional Investment Insurance

The investment insurance market is not in good health. Demand for traditional equity and lenders policies, covering expropriation, breach of contract, political violence and currency inconvertibility, is weak.

Lloyd's premium income figures for the risk code for confiscation and related perils (PR) dramatically illustrate this decline in demand, see Figure 1. ^{Note 1}



The figures show a slump in investment insurance business between 2001 and 2002, followed by a gentler, but continuing decline.

I would accept that part of this decline is due to Lloyd's losing market share on traditional investment insurance business over this period. However there is plenty of evidence that the rest of the investment insurance market has been having a torrid time.

OPIC's political risk insurance premiums have certainly been on the decline. We suspect the same applies to other national agencies. MIGA's premiums and exposure have at best plateaued. Non-Lloyd's private sector insurers have also been sending our distress signals about their investment insurance business.

Additionally, in absolute terms, the investment insurance market remains small. Hard figures are difficult to come by, but industry veterans agree that if you added the investment insurance premiums of the public and private sector insurers together, you would be hard pressed to reach USD500 million per annum, small in insurance market terms. Investment insurance is not a hot ticket.

^{Note 1} All premiums on policies bound in a particular year flow into that Year of Account. The four columns for each Year of Account show premiums received after 2 quarters (six months), 6 quarters (18 months), 10 quarters (30 months) and (for the 2003 Year of Account and earlier) the total received into the Year of Account by 30th June 2006.

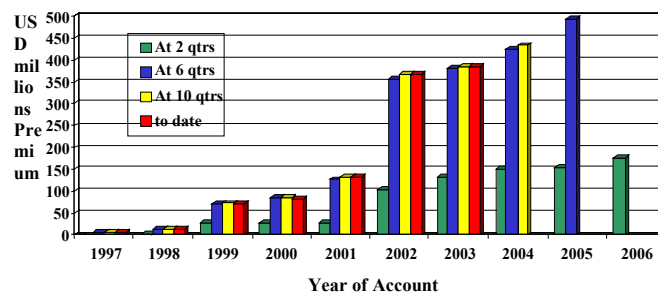
Nevertheless many of the underwriters employed by Lloyd's syndicates to write confiscation, contract frustration and related political risks have been very busy. They have turned their attention to the neglected area of the investment insurance market, political violence. Specifically, they have been writing terrorism insurance.

Growth of Stand-alone Terrorism Insurance

The stand-alone terrorism insurance market has grown dramatically since 9/11, fuelled by the decision of the general insurers and reinsurers to exclude terrorism from their general insurance policies.

Figure 2 shows Lloyd's premium income for stand-alone terrorism and political violence risks in recent years.

Figure 2
10 Year Overview of Lloyd's Premium Income for Stand-Alone Political Violence
(Risk Codes TO WL TE TU 6T)

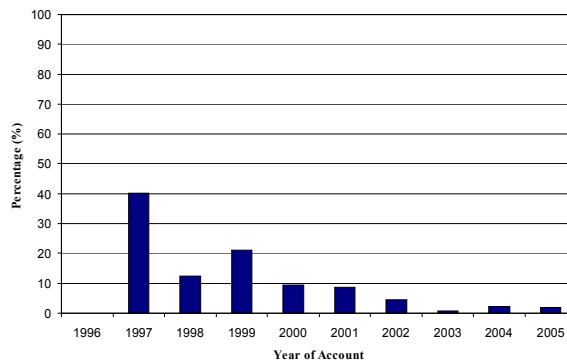


The terrorism insurance market clearly took off in the last quarter of 2001 following 9/11, and since then has continued to grow in absolute premium terms, despite premium rates probably now being less than half of their 2002 levels. Today, Lloyd's alone is writing USD500 million per annum of terrorism insurance premiums, a higher premium income figure than that of the investment insurance business globally.

The main Lloyd's practitioners estimate that Lloyd's market share is between one-third and a half of the total market. This means that the total stand-alone terrorism insurance market is now generating USD1.0 to 1.5 billion of premiums per annum.

The stand-alone terrorism insurance market has also been very profitable. Since the growth spurt in 2002, loss ratios in Lloyd's have been below 5% (see Figure 3). In some years they have struggled to reach 1%. Nor is this a class of business with a long tail. Losses are reported immediately, with generous reserves (fully reflected in the loss ratios in Figure 3) established within days or weeks of claims notification.

Figure 3
Incurred Loss Ratios for Lloyd's Political Violence Risk Codes
by Year of Account as of 30th June 2006



Indeed the class has been so profitable, that the underwriters in the market are eager to find any opportunity to pay claims to prove the efficacy of their product. The product they sell covers terrorism in a conventional property form. The T3 wording and its variants cover physical loss or damage to tangible property caused by terrorism, while the business interruption extension (T3a) covers loss of profits while damaged property is repaired and replaced. T3/T3a is used by both Lloyd's and non-Lloyd's terrorism insurers.^{Note 2}

The Separation of Terrorism Insurance and PRI: does it make sense?

The terrorism insurance market exists in its own separate silo in the insurance industry, sandwiched between the general property insurance market on the one hand and the political risk insurance (PRI) market on the other. This makes sense when contemplating terrorism insurance in North America or Western Europe. Indeed the terrorism insurance underwriters originally designed their T3/T3a wording with these countries in mind, and still write the majority of their business in the developed world.

However property in emerging markets is becoming an increasing part of the terrorism insurance business. Terrorism insurance is sold to the large emerging market projects that are of interest to the PRI market. Additionally, multinational companies buy terrorism insurance in global programs which include large amounts of property located in countries where PRI insurers have significant appetite for risk. Can the separation of terrorism and political risk insurance be sustained in this context?

Let us take as an example a typical project in the power or oil and gas sector in Russia. Let us assume that instead of a Moscow theatre or the Beslan school, Chechen insurgents attacked and seized the project. Let us assume that after a violent end to the siege, involving a battle

^{Note 2} An amended T3 wording was adopted by the Lloyd's Market Association on 1st September 2006 and is now known as T3 LMA3030. References to T3 in this paper are based on the latest LMA3030 version. However I will simply refer to it as T3, the name the market recognises.

between the terrorists and Russian security forces, the project is left damaged. The property damage is repairable with an estimated bill of USD50 million plus USD75 million of business interruption loss, incurred while specialist replacement equipment is manufactured, shipped and installed.

Let us also assume that the project has bought all four of the insurances involving elements of political violence cover that the insurance market now normally offers a project of this nature:

- the conventional property insurance, covering “all risks” of property damage, for a property damage limit of USD300 million, with business interruption insurance of USD100 million for a 12 months indemnity period
- stand-alone terrorism insurance for the same limit on the normal market wording
- equity form PRI, taken out by the foreign sponsor who owns 40% of the project. This has a limit of USD40 million representing 40% of the projects USD100 million equity
- lenders form PRI, taken out by the project financiers providing USD 400 million of cover for the lenders share of the USD 500 million project.

Who will pay the USD 125 million of property insurance losses the project has suffered? The answer is that despite the project’s insurance program having been blessed by the lenders insurance advisors (as the program is indeed in line with insurance industry best practice) and despite the project sponsors and lenders having bought USD 440 million of specialist PRI that includes political violence cover, only USD 20 million of the USD 125 million claim will be collected from this array of policies with any ease. The position on each policy is as follows:

- the conventional “all risks” policy covers riot and civil commotion, but will exclude war risks and, since 9/11, terrorism, so the loss is excluded.
- the stand-alone terrorism insurance covers terrorism but excludes the political risk market perils of “insurrection, rebellion, civil war and war”. The terrorism insurers would be entitled to argue that the Chechnyan conflict amounted to a rebellion or civil war, and decline cover, pointing the client in the direction of the PRI market’s policies who specifically cover these “war risks”.
- the equity PRI insurers should indeed provide some comfort. However they only cover property damage, not business interruption consequent on property damage, and they will only cover their policyholder’s share of the loss. They would therefore only be liable for 40% of the USD 50 million property damage claim, namely USD 20 million.
- the lender’s PRI insurers will resist the claim. They would acknowledge that the political violence fell within their causes of loss. However their indemnity is not geared to paying for the cost of repairing or replacing damaged property or for business interruption losses while the repairs are carried out. Rather their policy is geared to covering default on scheduled payments. However no default should occur: there is no reason that the project cannot be repairable, and once repaired, its very profitable continuing operations are more than ample to service the debt.

The lenders PRI insurers position is fair: they are not intending to offer property insurance. However, given the absence of the right type of property insurance, the lenders PRI insurers are the most likely target for a sue and labour type claim. They will not be happy, not because there is a claim, but because its not the type of claim they would expect to become embroiled in.

In summary, among the array of insurers who surround a project of this nature, none of them, with the limited exception of the foreign sponsors equity PRI insurers, is responsible for paying a simple property insurance claim due to the type of political violence that is commonplace in emerging markets. This is a product of blatant neglect by the insurance

industry, and a situation where no one involved emerges with much credit, be they insurers, brokers, insurance advisors or for that matter insurance buyers.

The neglect is based on the insurance industry's desire to treat terrorism and PRI as separate subjects. The industry views terrorism as belonging to the property insurance market, and writes terrorism following property insurance conventions. The PRI market likewise is generally reluctant to write coverage on property insurance forms, even for political risk perils. This mindset is ingrained in the industry and is responsible for the current neglect.

Industry mindsets are usually difficult to alter. To aid this process we have developed a four point philosophy about terrorism insurance in emerging markets that argues:

1. In emerging markets terrorism cannot be separated from war risks and political risk.
2. Insurance buyers have never had, nor ever will have, effective terrorism insurance for emerging market assets within their general property insurance policy.
3. The T3/T3a terrorism cover and its variants do not provide effective terrorism insurance for emerging market risks.
4. Only specialist PRI insurers can provide effective terrorism and political violence cover for assets in emerging markets.

Some may already share this view. Many will not. For the latter, the following addresses each of the points in detail:

1. Emerging market terrorism cannot be separate from war risks and political risk

Emerging markets are different. When it comes to terrorism this difference can clearly be seen in comparing the terrorist group that perpetrated the London bombings on 7/7, and Hizbullah that conducted the recent war in Lebanon. The difference can be understood by looking at the level of support enjoyed by these two types of terrorist organisations.

The 7/7 bombers acted covertly. Not even their close family members were aware of their planned attack. Secrecy was essential, as they knew even friends and family would have handed them over to the security forces. The London attacks were condemned almost universally, even among the Muslim community in the UK. Only a small group of fellow travelers have voiced any support. These people are so outside the main stream of political life in the UK that advertising their views immediately made them of interest to the police.

Hizbullah's situation is completely different. As the recent demonstration showed, when hundreds of thousands thronged the streets of Beirut to hear Sheik Nasrallah celebrate "victory" over Israel, Hizbullah enjoys huge support both locally and internationally. This political support enables their militia to engage with and at least frustrate the most powerful conventional military force in the region, the Israel Defense Force.

The 7/7 bombers were on the bottom rung of a terrorism ladder. Terrorism can escalate, stepping up the rungs of a ladder from insurrection, to rebellion, to civil war and war and ultimately to successful revolution. In stable, mature western democracies terrorism will remain a problem, but it is hard to imagine terrorist organisations ascending this ladder. But terrorist organisations in emerging markets can and do step up the ladder, and many, like Hizbullah, are high on its rungs. The engine that takes terrorist organisations up this ladder is political support from within their community, from outside, or from a combination of the two.

Throughout emerging markets you can see different terrorist organisations on different rungs of this ladder. Take insurrection. Since the toppling of Saddam, Iraq has had up to four separate insurgency movements operating inside its borders. But Iraq is not alone: the term “insurgent” is used almost synonymously with “terrorist” when referring to emerging markets, and many governments in the developing world have areas of their country in a constant state of insurrection.

Rebellion is the next step up the ladder. The MEND terrorists are staging a classical rebellion in the Niger Delta with clear local support and identified political aims. There have been countless other recent or ongoing rebellions in emerging markets, from those in the DRC, Uganda and elsewhere in Africa, to those in Thailand, the Philippines and Indonesia. Many of these rebellions are separatist movements, seeking independence for a religious, tribal or ethnic group trapped in the boundaries of what are often artificial nation states. As the power of nation states declines, many emerging market governments are finding it increasingly difficult to hold their states together. These states were often created by European imperial powers, and the population groups within their boundaries may have little in common. Balkanisation may not be limited to the Balkans.

Further up the terrorist ladder is civil war. I have mentioned Chechnya, but Sri Lanka too has drifted between rebellion, civil war and war in the language of the popular press. While the rungs on the ladder each have their separate names, Sri Lanka and Chechnya remind us how difficult it is to be precise about which rung a terrorist organisation occupies at a particular moment. Indeed the media are contemplating a two rung jump for Iraq, from insurgency to civil war.

Finally, when a terrorist organisation gathers sufficient political support, like Hizbullah, they can conduct a sustained, open war against conventional forces. Hizbullah is not alone: few media commentators doubt that the current conflict in Afghanistan is war.

Military historians recognise this type of warfare and contrast conventional war (between the official forces of rival nation states) to asymmetric war or low intensity war, namely war involving sub-national groupings and guerrilla or militia forces. They note that conventional wars have been in decline since the end of World War II, obvious exceptions being the Korean War, the Iran/Iraq War, the Falklands War and a few others.

In contrast low intensity war has been on the rise, beginning with the conflicts that marked the withdrawal of European powers from Empire: Malaya, Kenya and many more for the British; Indo-China and Algeria for the French; Congo for the Belgians; Angola and Mozambique for the Portuguese. A low intensity war was then fought by the USSR in Afghanistan. The Balkans was a low intensity war, with a conventional ending when NATO forces confronted Serbia. All or nearly all conflicts in recent years in Africa have been low intensity wars involving unofficial forces including Angola, the DRC, Uganda, Somalia and so on. The “War on Terrorism” is simply an umbrella name for a number of conflicts between conventional forces and many different terrorist groups on different rungs of the terrorism ladder.

The military historians make two points about low intensity warfare: first, the conventional forces hardly ever win; second, this type of war is contagious with success in one theatre, encouraging rebels and insurgents in another. Conventional forces, aware of their record, have learned that the key factor for success in these types of conflict is the hearts and minds of the local population, the water in which the terrorist fish swim. I will leave the reader to make his or her own judgement on whether the US-led War on

Terrorism is succeeding in winning the hearts and minds of local populations around the globe.

If the War on Terrorism goes badly, we will probably see a terrorist organisation achieve the top rung on the terrorist ladder: revolution. Revolution implies a successful rebellion. That means terrorist organisations achieving their often-stated goal of political power. This is at least a risk and if it occurs it may occur in areas of countries rather than involve a whole state. Ironically, the more authoritarian the local regime, the more likely it is to keep the lid on the pressure cooker. Equally, if authoritarian emerging market regimes begin to reform and move towards democracy, the risk of revolution will increase. This is the lesson learned as long ago as the French Revolution, recycled today as the J curve. Of course terrorist organisations may also achieve power by election, as Hamas have demonstrated.

My interest here though is the risk of a government being installed by revolution or, if you like, by force of armed revolt. Such governments tend to be expropriating governments, in the time-honoured tradition of the victor taking the possessions of the vanquished. This certainly happened following the last proper revolution the world saw in Iran in 1979. True, the expropriations were not accompanied by the legal niceties that PRI underwriters and their legal advisors like to see. But property was taken nevertheless. If this happens, some terrorist organisations will have attained their ultimate aim. For deep down many terrorist organisations and their supporters do not want to destroy the West's assets in emerging markets: they want to possess them.

Of course, sitting as we do in a mature, stable, western democracy, it is quite impossible to think of any terrorist organisation here gathering sufficient political support to ascend the rungs of the terrorism ladder. But emerging markets are different. By definition emerging market countries have weak, immature and unstable political, social and economic systems. Many also have large, disaffected, young and poor populations, who feel that the only outlet for their frustration is to support, directly or indirectly, the activities of those who have taken up arms against the established order. It is this local support together with assistance from outside the country that propels the terrorists up their ladder.

In summary, I have not forgotten Hugo Chavez, Alvo Morales and President Putin. Opposition to globalisation and western culture takes many forms. However, global terrorism, particularly radical Islamic terrorism, is central to the political risk faced by international business in emerging markets. Global terrorism cannot be separated from war risks as terrorists on different rungs of the ladder are engaged in insurrection, rebellion, civil war and low intensity war – all war risks in insurance terms, as we will see. Additionally global terrorism represents political risk. This is because it is political support, whether from within or without their theatre of operations, that propels terrorist organisations up the terrorism ladder. This support, if sufficiently strong, may propel terrorist organisations into government, either by the ballot box (as we have seen with Hamas) or by the Kalashnikov in the form of violent revolution.

We can now proceed to the more prosaic question of how the geo-political risk of global terrorism is addressed by the insurance industry in their policies.

2. Insurance buyers have never had, nor ever will have, effective terrorism insurance for emerging market assets within their general property insurance policies

Insurance buyers were not focused on terrorism insurance before 9/11. Their property policies often covered “all risks” of property damage, except for specifically excluded risks. As terrorism was not excluded, buyers could assume it was covered.

Terrorism insurance only became an issue when terrorism exclusions were added to property policies after 9/11. Naturally insurance buyers focus on this new exclusion. If they can remove the terrorism exclusion, surely they will once again have cover for terrorism.

For their assets in North America and Europe, where terrorists occupy only the bottom rung of the ladder, they may well be right. But in emerging markets they are wrong. The reason is to be found in the war exclusion.

Since the 1937 War Risks Agreement, (of which more later) general insurance policies have contained a broad exclusion of war risks. The wording of a typical war risks exclusion is contained in Box 1. The exact wording of this exclusion has evolved over the years but the themes remain the same.

It will immediately become clear that the war exclusion excludes far more than conventional war. Even if “war” were interpreted to only mean war between nation states, other types of sub-national conflict including civil war, revolution, insurrection and rebellion are specifically excluded.

Box 1: General Property Insurance Market War Exclusion

Notwithstanding anything to the contrary contained herein this Policy does not cover loss or damage directly or indirectly occasioned by, happening through or in consequence of war, invasion, acts of foreign enemies, hostilities (whether war be declared or not), civil war, rebellion, revolution, insurrection, military or usurped power or confiscation or nationalisation or requisition or destruction of or damage to property by or under the order of any government or public or local authority.

Box 2: Legal definition of “Rebellion”

Organised, armed and forcible resistance to the government of the country by its subjects (even though assisted from without). An essential aim is the intention to supplant or overthrow the government, even though in all the circumstances that aim may appear unlikely or impossible of achievement. Rebellion includes territorial separatists whose aim is to deprive rulers of authority over part of their territory.

Source: Michael D. Miller: Marine War Risks. Lloyd's of London Press, 1990

The legal definition of rebellion is contained in Box 2. It makes clear that when an organised group takes up arms against the state with the intention to overthrow it, the war exclusion applies. Any separatist group with the aim of achieving power over a region of country are “rebels”. Many if not most terrorist organisations in emerging markets fit the definition of “rebellion” very well.

The war exclusion also excludes confiscation, as the two often walk hand in hand. In effect therefore when talking about physical property, the perils the property insurers refer

to as “war risk” are the same perils the investment insurance market call “political risk”^{Note 3}.

The war risks exclusion is unlikely to exclude terrorism in the developed world. It would be difficult to say that the 7/7 bombers were involved in an insurrection in the UK. But emerging markets are different. Where terrorist organisations in emerging markets gather sufficient political support, they start ascending the terrorism ladder. When their activities amount to insurrection or rebellion, the war risks exclusion comes into play.

The war risks exclusion is a fixture in property insurance. No one in the industry believes it should be removed and it is the war risks exclusion that excludes the activities of terrorist organisations that begin to ascend the emerging market terrorism ladder.

3. The terrorism insurance market’s standard T3/T3a wording does not provide effective terrorism insurance for emerging market assets

The definition of “Act of Terrorism or Sabotage” in the T3 wording is shown in Box 3. Note the reference to “influencing” government, not “overthrowing” government.

<p>Box 3: T3 Act of Terrorism or Sabotage definition</p> <p>An Act of Terrorism means an act or series of acts, including the use of force or violence, of any person or group(s) of persons, whether acting alone or on behalf of or in connection with any organisation(s), committed for political, religious or ideological purposes including the intention to influence any government and/or to put the public in fear for such purposes.</p> <p>An act of sabotage means a subversive act or series of such acts committed for political, religious or ideological purposes including the intention to influence any government and/or to put the public in fear for such purposes.</p>	<p>Box 4: T3 War Risks Exclusion</p> <p>This Policy does not insure against loss or damage occasioned directly or indirectly by war, invasion or warlike operations (whether war be declared or not), hostile acts of sovereign or government entities, civil war, rebellion, revolution, insurrection, martial law, usurpation of power, or civil commotion assuming the proportions of or amounting to an uprising.</p>
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Nevertheless, the issue with the T3 wording in the context of emerging market terrorism is that it contains a full war risks exclusion. The exclusion in Box 4 is Exclusion No. 2 of the T3 wording. Other political risks like confiscation, riot and civil commotion are excluded elsewhere.

As we have seen the activities of many terrorist organisations in emerging markets are better described by the words in the war risks exclusion than by the definition of “Act of Terrorism”. Additionally, T3 contains a reverse “Onus of Proof” clause: the underwriters

^{Note 3} On a historical note, confiscation and “takings” of property were considered by many as the main war risk. Marine insurers have long divided traditionally marine risks and war risks into separate policies. Prior to 1983 when the marine insurance wordings were rewritten, the war exclusion in a marine insurance policy was referred to as the FC&S Clause. This stood for “Free of capture and seizure”, antiquated language, but highlighting confiscation and the like as the main source of war risk losses.

can require the policyholder to prove that the war risks exclusion does not apply. Of course, following the normal rules of construction, if as is likely, a loss fits both the definition of “Act of Terrorism” and falls within the war risks exclusion, the exclusion will overrule the cause of loss: exclusions trump the insured peril.

Having said that, the T3/T3a wording is not completely useless. The wording was designed for the developed world, and is arguably adequate in the context of New York, London or Brussels. It works for the lowest rung of the terrorism ladder.

Even in the context of terrorism outside of North America and Western Europe the T3 wording still provides some cover. Indeed the wording has paid claims for losses in emerging markets, as its supporters are keen to point out. However these claims payments testify to the integrity and commercial judgement of the underwriters: they want to pay these claims. The wording has not been put to a legal test.

However, we have taken the T3 wording to a Queen’s Counsel in the UK who specialises in insurance law in this area. His verdict was that in the context of emerging market terrorism, the T3 wording is a “dog’s breakfast” – a mess in other words. In his view the war risks exclusion removes much of the cover promised by the cause of loss.

The QC stressed the practical difficulty to be found in any policy that covers some types of political violence while excluding others. In other words, the terrorism ladder is easy to understand, but deciding which rung a terrorist organisation occupies on this ladder at a particular place and time, is very difficult. No doubt this disinterested advice was given by the QC in the confident knowledge that many in our industry would continue to ignore it.

Many insurance buyers may assess the terrorist threat in a particular emerging market today as relatively low, but buy cover recognising that the security situation may deteriorate. The situation deteriorates when local support for the terrorists rises, and the terrorists ascend the ladder. As this happens the chance of you having a terrorism loss rises, while the chance of the T3 wording responding falls. In other words with the T3 wording, the more you need terrorism and political violence cover, the less likely you are to have it.

Many in the property insurance world are so convinced in their own mind that “terrorism” and “war” are separate risks, that they believe that if an act constitutes terrorism, then by definition it cannot be war. They have convinced themselves that the “war exclusion” as they call it, only excludes conventional war and the actions of conventional military forces. In effect they believe that if the damage is caused by a terrorist organisation, cover applies, but if it is caused by conventional forces it is excluded.

This is fantasy in the context of T3. If the terrorists are involved in insurrection, rebellion, civil war or war, their actions are excluded by T3. However let us indulge the T3 supporters for a moment and pretend they are right. They are saying in effect that if in a conflict like Lebanon your property is hit by a Hizbullah rocket you are covered, whereas if it is hit by an Israeli artillery shell or bomb, you are not. Even on this interpretation T3 does not work for emerging markets. The typical military engagement in the 21st Century will continue to be one between conventional forces and “terrorists”. Even on the erroneous interpretation of T3 put forward by its supporters, if your property is damaged in such an exchange, your ability to claim will depend on you being able to show which side of the conflict fired the missile that caused the damage. In emerging markets today, T3 is not a viable grant of cover.

Buyers should take heed. So should insurers and brokers, given current demand for contract certainty. When used in the context of emerging markets the T3 wording has a glaring internal inconsistency that needs ironing out. In the meantime either the capital providers and reinsurers are covering a risk they had not bargained for, or the policyholders do not have the cover they have paid for.

I suspect the risk here is with policyholders. I believe insurance policies usually deliver on their promise. T3 promises to exclude losses caused by insurrection, rebellion, civil war and war. The wording is inconsistent with the apparent intent of the insurers who imply they are covering terrorist activity on all rungs of the terrorist ladder. Our view is that if terrorism insurance wordings for emerging market assets do not start to say what is meant, policyholders will find out that the policies mean what they say.

4. Only specialist PRI insurers can provide effective terrorism insurance for assets in emerging markets

By now it will be clear that the solution for emerging market terrorism wordings is to take the terrorism insurance market's property form (geared to property damage and business interruption) but to remove or severely restrict the war risks exclusion, and to take the words from the exclusion and place them in the causes of loss.

Exactly which words you need to place where will depend not on a judgement of which rung on the ladder the terrorists operating in the country sit today, but rather on how high up the ladder they might ascend, should they gather further political support. This in turn will depend on a judgement of the stability of the country's political and social framework internally and the terrorists' political alignments externally.

By definition, where these wording improvements occur, the terrorism insurance and PRI markets will have merged. If you venture into the territory covered by the war risks exclusion, you are by definition a specialist PRI underwriter.

The merger of the terrorism insurance and PRI market has already begun

The idea of moving your emerging market terrorism business from the T3 terrorism insurance market to the PRI market is not wishful thinking. We have done it. Furthermore we know it can be done economically.

In September 2003 we launched our Global Political Violence Insurance wording. This provides property insurance for political violence including not only terrorism but also such risks as insurrection, rebellion, civil war and war. Later that year we moved an Asian energy project's USD100 million of terrorism cover from the T3 market to the PRI market. Instead of excluding insurrection, rebellion, civil war, war and confiscation, their renewed terrorism policy covered all these risks. Additionally, their premium went down. Since then we have done the same for projects elsewhere in Asia, in the Middle East and in Latin America. We have also taken global T3 terrorism policies and replaced them with programs on the Global Political Violence Insurance wording, a PRI product. We do not get the opportunity to do this unless the client saves money too.

So the transition is already underway. We have begun the merger between the terrorism insurance and PRI market.

As the merger continues the drivers should be from both the demand and the supply side.

Insurance Buyers need to drive demand

On the demand side, more insurance buyers should simply look again at the nature of emerging market terrorism and the wordings of their policies. They will then demand that the war risks perils are removed from the exclusions and become insured perils. They will then find that their terrorism insurance can only be supplied by PRI insurers.

London market insurers are best placed to drive the supply

On the supply side there are two groups of PRI insurers. The first group are those who currently write both PRI and terrorism insurance in the same area of their account. These insurers are mainly Lloyd's syndicates or insurers with a background in the London market and war risks. For them the transition will be easy: as and when more policyholders demand a better terrorism insurance cover, they are equipped to meet that demand.

This group of insurers may want to be more pro-active. They may want to take on board our second point, that the general property insurers will still not be covering emerging market terrorism insurance effectively even if they remove the terrorism exclusion from general policies. This is starting to happen, and where it does the T3 market loses business. Indeed the major threat to the niche occupied by the T3 underwriters is from the softening general property insurance market. This drift of business back to the property insurers can in part be stemmed if the T3 insurers start promoting a wider product for emerging markets. Obviously though, if they begin to focus clients minds on the war risks exclusion in their property insurance policies, they will have to remove the war risks exclusion from their own terrorism policies.

Traditional private PRI insurers need to change their view on providing PRI in a property insurance form

The second group of insurers are those currently writing convention equity and lenders form PRI, who have not yet fully entered the terrorism insurance market. These insurers are mainly based in the US, but there are still some Lloyd's PRI insurers of the same mindset. If these insurers also have a pitch in the terrorist insurance market elsewhere within their large organisations, it is far removed from the PRI department. This group of insurers, key capacity providers to the PRI market, needs to have a longer rethink.

Traditional investment insurers have never made a good job of writing political violence insurance.

Most buyers of political violence insurance are looking first and foremost for property insurance: they expect coverage for property damage (PD) to tangible assets and for conventional business interruption (BI) consequent on such physical damage. This is exactly what T3 delivers: it is the right policy form, albeit with the wrong perils and exclusions. Investment insurers have not traditionally offered Property Forms, but rather have sold political violence cover in Lenders or Equity Forms. As we have seen, neither provide effective property insurance.

For the private insurers the reason for this neglect can be found in the 1937 War Risks Agreement entered into by most London and international insurers that banned insurance of war risks for land-based assets. This agreement, nearly 70 years later, is still in force and has cast a very long shadow over the PRI market.

Although some insurers established after the War Risks Agreement such as PanFinancial, began offering war on land insurance in the 1980s it was not until the mid-1990s, 25 years after the private insurance market began writing political risk insurance, that exemptions were granted to permit specialist PRI insurers to write full political violence cover for land-based assets, including war, civil war and related war risks. Though the regulatory shackles have been lifted, many of the myths and taboos of the 1937 Agreement prevent private insurers from taking a clear and rational approach to political violence insurance.

But it is not just regulation that has caused the neglect: insurers, both private and public, have shunned political violence insurance as a matter of choice.

Much of the conventional wisdom about underwriting PRI on investments originated in Washington. Central to the philosophy of OPIC and MIGA, is their “umbrella”: that they can influence governments and prevent losses. Secondly, when the “umbrella” fails, paid losses should be recoverable over time. Though OPIC has a program offering terrorism insurance the doctrine of prevention and recovery has generally steered government agencies away from focusing on property damage related political violence policies. Many in the private market, particularly those close to Washington have followed this philosophy. They need to rethink.

While rethinking the insurers need to consider the current malaise effecting the investment insurance business. They need to respond to the current demand for war risks cover (in its widest sense) in a property insurance form. Without a change of direction, the investment insurers business is soon going to consist only of a form of host government bonding, with private insurers standing surety for host governments in an effort to shield major infrastructure investors in particular against the obsolescing bargain. This is a product that, despite years of effort, is proving very difficult to construct in a manner that works for both insurers and policyholders at the same time. BITs may or may not help.

A broad change of direction for the investment insurance market

Indeed when the investment insurance community focuses on an emerging market project, I sometimes wonder whether the insurers, the sponsors, the lenders and the advisors are not focused on the wrong government and the wrong risk. The obsolescing bargain risk associated with the current host government is of course a real risk. But the current government would not be promoting the project unless they wanted it to succeed. So as long as the current administration is still in place, even if they seek to renegotiate the terms, a compromise is normally available. This alone often can make conventional PRI insurance a complication.

Meanwhile what about terrorist organisations in the host country whose aim is to replace the government. If the political tide swept them up the terrorism ladder into power, it is likely the sponsors, lenders and advisors would have no leverage with the new government. This of course is a remote risk in most emerging markets. However, the risk of terrorist attack on infrastructure projects is not: in fact it is bound to happen somewhere at some time in the future. Depending on the severity of the attack and the level of turbulence in the country at the time the project will either be rebuilt or abandoned. Either outcome needs the insurance

market. Yet most emerging market projects either have no cover for this risk, or only the very limited T3 cover. This is the area where the PRI market really can make a difference.

Confronting insurance industry prejudice and taboos

PRI insurers have begun to grasp the nettle. But in treating terrorism as a war risk and seeking to write it in a property form, insurers have to face the insurance industry's number one taboo, the class of business that hardly dare speak its name: war risks on land.

Though the 1937 War Risks Agreement was put in place nearly 70 years ago, its effect is felt throughout the insurance industry, as the war risks exclusion that it generated has been hard-wired into the DNA of the industry through the reinsurance market. For a long time minds have been closed on the subject. Indeed it is this mindset that has erected the wall that separates the two silos: terrorism insurers on one side, writing property insurance, but not daring to look the war risks exclusion in the face; and PRI insurers on the other, writing war risks, but not on a property form. The time has come to take a fresh look at the 1937 Agreement.

Of course the basic principle behind the Agreement stands. To quote Lloyd's own comment on the Agreement, that principle was "the need to ensure that war risks are only written in a carefully controlled manner". That remains an absolute requirement.

In 1937 they devised a system of controls for marine war risks, marine insurance still being at that stage, the main business of the market. Those controls have remained the basis of the Marine War Risks market (and the Aviation War Risks market) to this day. However they felt at the time they lacked the systems and, indeed the authority, to produce a satisfactory framework for controlling the aggregations associated with land-based assets: hence the ban.

Times change however. Not least the nature of war has changed. In 1937 the most likely form of warfare facing the world was conventional war on an industrial scale. That today remains possible, but less likely, and the type of low intensity war currently in vogue is inherently a better environment for writing a book of war risk business, not least as the terrorists ability to strike anywhere in the world reduces the problem of adverse selection.

However the main change relevant today is the insurance market's progress in developing sound underwriting systems for classes of business capable of producing catastrophic losses. Additionally, unlike in 1937, we now have a specialist private PRI market with a 30 year track record that has successfully devised systems for controlling aggregates, including aggregates for the "war risk" with arguably the highest aggregation exposure, confiscation.

Reinforcing sound PRI market underwriting principles

Therefore in embracing war risks more firmly, PRI insurers need only reinforce the principles that have guided the market for 30 years. These include:

1. The private insurance sector cannot deal with the totality of war risks/political risks

War risks like political risks generally can produce mega-catastrophes. By a mega-catastrophe I mean one that exceeds the capability of the insurance market to absorb, given the capital deployed in the industry.

It does not follow that where the potential for a mega-catastrophe exists, that the class be banned altogether. The natural world has the potential for mega-catastrophe too. AM Best, the insurance rating agency, says it is “only a matter of time” before a hurricane event generated insurance property losses of USD100 billion, and that that would make up to 40 insurers vulnerable to failure. But what about the USD200 billion hurricane or the USD300 billion earthquake or the USD400 million tsunami. These types of exposures are within the range of the possible, but do not stop the industry writing property insurance. Rather they control aggregates using modern technology. For this reason the supply of catastrophe insurance from the conventional insurance industry can and does dry up.

2. Only specialist insurers should write political risks/war risks

There is no argument to be made for allowing general insurers to write war risks and political risks in their general property account. These classes should only be written by specialist insurers.

There is of course an exception to this: general insurers can write insurance for classes with a mega-catastrophe potential where they are underpinned by a government backstop. In the developed world such backstops were already in place for terrorism risk in the UK and Spain. Post 9/11 similar government schemes were created for terrorism insurance in such places as the USA, France and Germany, the more successful ones in the form of a government reinsurance safety net.

In the developed world, there remains a threat of a terrorism mega-catastrophe should terrorists obtain and deploy weapons of mass destruction (WMD), a very remote but nevertheless possible event we are told. For this reason if no other I believe these government safety nets should stay in place. Having terrorism covered in general policies that benefit from a government safety net is a good model for the developed world.

If this model continues, the main opportunities for specialist terrorism and war risk underwriters will continue to drift away from the developed world to emerging markets, the countries where PRI insurers focus their attention and have their expertise and capacity.

3. Extreme war risks excluded

PRI policies normally contain exclusions of war between the Five Permanent Members of the UN Security Council and exclusions relating to WMD. That should continue. In this regard the PRI insurers build in greater safety limits to their books of business when it comes to the potential for mega-catastrophes. The insurers exposed to mega-catastrophes from natural perils do not have equivalent exclusions for extreme natural events.

4. Strict monitoring of aggregates

Terrorism insurers monitor aggregates very closely by postal address. As long as risk is well spread within a country or even within a city, the city or country aggregate is less important. That is appropriate for developed countries where terrorist activity is likely to remain only on the lowest rung of the terrorism ladder, where the threat is of covert, isolated attacks by terrorist organisations with little or no political support from the local population.

In emerging markets, where terrorist organisations can and do climb the ladder, powered by political support, aggregations at the city, district and country level are far more important. PRI insurers have these country aggregation systems in place.

5. Limited supply of war risk insurance

Monitoring of aggregates will limit the supply of war risk insurance. This has two effects. Firstly, even with an active war risks insurance market, most war risk losses will still be uninsured. Even with an active terrorism insurance market, most terrorism property losses since 9/11 have been uninsured. ^{Note 4} Likewise, when Bolivia expropriated the oil industry earlier this year, a loss of about USD4 billion, none of that loss was apparently covered by expropriation insurance, despite 30 years of effort by the PRI market selling insurance for expropriation.

The second effect of the limited supply of war risk insurance that results from monitoring aggregates is that a floor is placed under prices. Because each insurer has finite country capacity, the PRI market does not suffer from the extremes of price competition that drives the cycle of most insurance classes. Pricing of war risks by the PRI market will have the same characteristics as other PRI products: insurers will be able to hold out for a price that reflects the risk, or save their country aggregate for a better opportunity.

6. Co-operation with the Government sector

Co-operation with government schemes and insurers has always been a feature of the PRI market.

Likewise, while you have to go back a long way, co-operation between private and public insurers has been a feature of war risks insurance. For example, during the First World War business was shared between Lloyd's and the UK government. Lloyd's made profits on all sections of its war risk business. The UK government lost £7.5million on their cargo business. However the government more than made up for this on their hull and war on land account, netting a profit of £32 million overall. Again the two co-operated in the Second World War. There has long been a feeling at Lloyd's that writing a properly controlled war risk account can be very profitable, particularly in time of war.

Looking into the future, as the private PRI market develops as a writer of terrorism and war risk in emerging markets there may come a demand for aggregate capacity beyond the prudent reach of private insurers. Reinsurance from governments might then seem sensible. If it does, MIGA would be ideally placed to deliver such a reinsurance on a commercial basis. MIGA might need some time to think that idea through: happily they have some time, while the private PRI market uses its latent and under-utilised internal capacities.

These principles for writing war risks are well established PRI principles. They simply need applying to a new area, the writing of terrorism and war risks in emerging markets. The only principle insurers need to revise is that paid losses should be recoverable over time. When writing terrorism and war risks, paid claims have to be met from premiums earned.

^{Note 4} For the skeptics, this is not because claims have been denied under T3. Rather it is because the vast majority of assets around the world have no terrorism cover.

Learning from the stand-alone terrorism insurance market

I have a reputation in London as a critic of the terrorism insurance market. It is true I am a severe critics of their standard T3 wording being used for emerging market risks. I have kept on about the market's wording because T3 in the context of emerging markets is so wrong, and can so easily be put right.

That aside, I nevertheless recognise that the terrorism insurance market has been a spectacular example of the insurance industry at its best, responding rapidly to changed demand and filling an urgent need. Furthermore they have made spectacular profits in the process. In doing so they have reminded us that writing war risks in a controlled manner can bring rich rewards, particularly in time of war. After all global terrorism is a war risk.

In conclusion, the wind has shifted. Buyers of insurance are less interested in expropriation and the obsolescing bargain; they are more interested in terrorism and political violence insurance, which they sense is a greater geo-political risk. The insurance market has so far not giving them the right cover to deal with this risk, and only PRI policies can fill the void. The investment insurance market needs to take advantage of this opportunity and shift tack. This shift does not mean abandoning other more traditional PRI covers: emerging market terrorism risk should be an additional reason for using the PRI market, not the only one.

To grasp the opportunity you need only remember four key points

1. In emerging markets terrorism cannot be separated from war risks and political risk.
2. Insurance buyers have never had, nor ever will have, effective terrorism insurance for emerging market assets within their general property insurance policy.
3. The T3/T3a terrorism cover and its variants do not provide effective terrorism insurance for emerging market risks.
4. Only specialist PRI insurers can provide effective terrorism and political violence cover for assets in emerging markets.