

Commercial terrorism insurance in Germany (Extremus)

As was also the case in many other countries, German insurers at the end of 2001 refused to renew terrorist insurance beyond the expiration date of existing contracts. Unlike the French system, there is no obligation under German law for insurers to include terrorism coverage in their basic contracts. They were able, therefore, to continue to provide coverage for policyholders of property and casualty insurance but with a considerable reduction of terrorism coverage, or even its total exclusion. Since they had no reinsurance capacity, most of them chose this latter option. After more than six months' discussion between representatives of the insurance industry and the German federal government, agreement was reached on the creation of a public-private partnership. The partnership is based on the creation of a new insurance company covering terrorism only, Extremus, incorporated on November 1, 2002.

Structure of the partnership

Extremus was modified several times in the first two years. What follows has been updated to represent the mode of operation in 2004. Risk sharing is organized in successive layers of exposure. Unlike the French pool system working as reinsurers, firms can transfer their terrorism exposure directly to Extremus which therefore acts as a direct insurer. Coverage is organized into three risk sharing levels on an annual aggregate stop loss basis.

A first tranche of 1.5 billion euros is covered by Extremus. A second 500 million tranche is covered by several insurers and reinsurers including the American insurer Berkshire Hathaway (Warren Buffet). The private sector is therefore covering the terrorist risk in Germany up to 2 billion euros, as is the case in France. Beyond that, the German federal government offers limited guarantee up to 8 billion euros. Premiums are distributed between Extremus shareholders and partly repaid into the higher reinsurance tranches. As an example, in 2003, the German federal government was collecting 9% of premiums received by Extremus for its reinsurance coverage.

It is worth noting that Extremus is liable for all the insured losses as a result of terrorist action on German soil. It has private and federal reinsurance cover for a total exposure of 10 billion euros. According to German corporate law, the company's liability is limited to those 10 billion euros. Should a very large scale terrorist attack cause losses higher than that cap, Extremus would have to announce insolvency and a large number of firms might not be reimbursed.

Terrorism coverage

In contrast to the French system, insurance against terrorism is not mandatory for corporations in Germany. This is an essential difference between the two approaches. Firms who wish to take out cover against terrorist action can only do so for insured values over 25 million euros and for risk located in Germany. chemical, biological, radiological or nuclear (CBRN or "ABC" in Germany) risks are excluded. A firm cannot take out coverage for a single risk (for instance a single building); it must cover all of its activities.

As is the case in France, the price of coverage depends on the total value insured by the firm and not on location of the risk. Furthermore, the price varies with the maximum annual amount of compensation for terrorist risk chosen by the firm. This annual compensation is capped at a maximum of 1.5 billion euros. In other words, a firm whose total insured value is 7.5 billion euros cannot get coverage for more than 1.5 billion and is therefore without cover for 80% of its total exposure. Choosing a lower compensation figure, for an identical insured value, secures a lower insurance premium for that firm.

The following examples of pricing are based on data supplied by Extremus management:

- For a total insured value (TIV) of 25 million euros and a maximum annual compensation (MAC) set at 25 million, the premium is set at 6250 euros, (0,025% of TIV and 0,025% of MAC);
- For a total insured value (TIV) of 75 million euros and a maximum annual compensation of 25 million, the premium is set at 10 625 euros; (0,014% of TIV and 0,043% of MAC);
- For a total insured value (TIV) of 200 million euros and a maximum annual compensation of 100 million, the premium is set at 84 038 euros; (0,042% of TIV and 0,084% of MAC).

Insurance demand

Although the mutualization systems adopted by both France and Germany are similar on several counts, the fact that terrorism insurance is not mandatory in Germany produces a radically different market. Data available on the German market as of the summer of 2004 also revealed a very low demand level.

According to Extremus, only 1000 contracts were covered in 2004, for a total premium income of 77 million euros, a TIV of 365 billion dollars and a global MAC commitment of 74 billion euros for that same year. To put this figure of a thousand policies in perspective, it is estimated that the number of insurance policies for which TIV does not exceed 25 million euros (threshold which triggers access to Extremus coverage) add up to 40,000. In other words, on average, only 2.5% of policies eligible for terrorism coverage are in fact covered (Michel-Kerjan et Pedell, 2004). Demand is even limited with the larger corporations. In 2004 again, only 13 out of 30 corporations listed on the German DAX30 stock exchange index (equivalent of the French CAC40) had bought anti terrorist cover. (Frankfurter Allgemeine Zeitung, 2003). This extremely low demand is all the more surprising after the events in Hamburg at the end of December 2003 and those of Madrid in March 2004.

Several reasons may have contributed to this lack of interest on the part of the German business community in coverage against terrorism. Firstly, Extremus only covers risks situated in Germany. Coverage of subsidiaries of multinationals - whose activity would be affected if their head office in Germany was attacked - would be excluded (interdependence). Secondly, the risk of chemical, biological and nuclear attacks is not covered, whereas this is probably the risk that companies fear most. It is true that a single such attack would not only have devastating direct consequences, but that also the effects would be long lasting, so that business interruption would be prolonged. Finally, as is the case in the French system, a firm that has made major investments in protective security measures does not get a better rate than a firm that has made no such investment.

In this low coverage context, if a large scale terrorist attack were to take place tomorrow in Germany, most firms would have no cover and would have to shoulder the full financial consequences of the catastrophe. Unless the federal government came to their rescue, several of them would certainly go bankrupt with considerable economic and social consequences for the country as a whole.

So as to make its coverage offer more attractive to a greater number of firms, Extremus is presently considering several changes. One of the modifications on the drawing board would seem to be very innovative. The coverage on offer would be dual, both against attack in Germany and to cover business interruption in other countries of the European Union. In other words, there would be at least partial integration of the international characteristics of economic activity and of supply and sales networks.

As an example, let us imagine a German electronics firm whose head office is in Berlin and has assembly lines in the Paris area. If the French subsidiary came under terrorist attack, it would be covered by the French Garet system, and the economic losses sustained because of business interruption due to breakdown of the supply line in Berlin would be covered by Extremus.

If such a modification is actually implemented and a significant increase in the demand for cover in Germany occurred as a result, it would certainly be a trailblazer for other kinds of coverage combinations in several other countries of the Union. It is a fact that so far, the issue of financial cover for the consequences of terrorist action has been broached on a purely national basis, with no concrete recognition by insurance markets and governments of the transnational character of economic activity, the major infrastructure networks, and of terrorism itself.

A temporary partnership

The partnership between Extremus and the Federal government has been established for three years and therefore comes to a close at the end of 2005. However, the Federal Finance Minister has recently stated that government support could be withdrawn in 2006 if the level of demand remains as its present low level. – **This was extended until December 31, 2007.** Thereafter is of yet uncertain.