

The Senate

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Economics Legislation Committee

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Provisions of the Terrorism Insurance Bill 2002

May 2003

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# Senate Economics Legislation Committee

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# Chapter 1

## Inquiry into the provisions of the Terrorism Insurance Bill 2002

### Referral

1.1 On 19 March 2003 the Senate referred the provisions of the Terrorism Insurance Bill 2002 to the Economics Legislation Committee. The referral arose from a recommendation of the Selection of Bills Committee that the Committee examine the operation of the proposed scheme, including coverage, premium levels, and the impact on the insurance industry and property owners. The original reporting date of 30 April 2003 was subsequently extended to 13 May 2003.

### The Committee's inquiry

1.2 The Committee invited a number of interested parties to make submissions on the provisions of the Bill. The inquiry was also advertised on the Parliament's website and in the *Australian* on 26 March 2003. The Committee received 12 submissions representing views from the banking sector, insurance and industry groups, professional risk managers, small business and state governments. A list of the parties from whom submissions were received appears at Appendix 1. Copies of submissions are available on the Committee's website at [www.aph.gov.au/Senate](http://www.aph.gov.au/Senate).

1.3 A public hearing was held in Canberra on Thursday, 1 May 2003. A list of parties who appeared at that hearing appears at Appendix 2. The transcript of that hearing is available at [www.aph.gov.au/hansard/senate/commtee/s-econ.htm](http://www.aph.gov.au/hansard/senate/commtee/s-econ.htm).

1.4 The Committee thanks all those who contributed to its inquiry by providing submissions and giving evidence.

### Legislative history

1.5 The Terrorism Insurance Bill 2002 was introduced into the House of Representatives on 12 December 2002. The Bill was debated in Main Committee on 26 March 2003 and passed with eight government amendments. Except as otherwise noted, references in this report are to the bill in its amended form, technically the Terrorism Insurance Bill 2003.

### Background

1.6 The Terrorism Insurance Bill is a legislative response to the withdrawal by insurance and reinsurance companies of cover for terrorism risk after the events of 11 September 2001 and the effects of the absence of such cover on the commercial property sector.

1.7 An assessment of the Australian market undertaken for the Treasury by Trowbridge Insurance in mid-2002 found that ‘virtually no terrorism-related insurance cover is available for commercial property and business interruption.’<sup>1</sup>

1.8 The Property Council of Australia concurs with this assessment, submitting that, while it is possible to get terrorism cover ‘it is totally inadequate for the needs of the marketplace, there are very major exclusions, the definitions of “event” and “terrorism” are ambiguous, the cover is totally inadequate in terms of whether it would deal with chemical or biological attack and it rarely deals with business interruption and public liability.’<sup>2</sup>

1.9 The explanatory memorandum to the Bill notes the broader economic consequences of the absence of such cover:

With a large pool of assets uninsured for terrorism risk, financiers and investors face uncertainty that could result in adverse economic circumstances, delaying commencement of investment projects and altering portfolio management decisions.<sup>3</sup>

1.10 This is echoed in the submission from the Australian Bankers’ Association:

The inability to obtain insurance cover for acts of terrorism is significant not just for current projects, but also for projects that may be undertaken in the future. There are many future projects that simply may not proceed if appropriate insurance cover can not be arranged. The Banks need Government support in establishing a solution to cover both existing projects, as well as future projects, until the matter can be resolved in the longer term.<sup>4</sup>

1.11 The Bill aims to ensure the availability of insurance cover for terrorist risk and in turn to restore the requisite certainty to the commercial property sector.

## **Policy objectives**

1.12 The Government is seeking to establish a terrorism risk insurance scheme as an interim measure to address a market failure: the market’s inability to price terrorism risk for the purposes of insuring commercial property. Government involvement is ‘directed at alleviating problems faced by commercial property owners who are unable to obtain terrorist risk insurance.’<sup>5</sup>

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<sup>1</sup> *Revised Explanatory Memorandum*, p. 4.

<sup>2</sup> Mr Peter Verwer, Chief Executive Officer, Property Council of Australia, *Proof Committee Hansard*, p. 8.

<sup>3</sup> *Revised Explanatory Memorandum*, p. 5.

<sup>4</sup> Ms Ardele Blignault, Director Government and Stakeholder Relations, Australian Bankers’ Association, p. 2.

<sup>5</sup> *Revised Explanatory Memorandum*, pp. 6-7.



1.13 The Government decided that its intervention in the area of terrorism risk insurance would need to be consistent with the following objectives:

- the need to maintain, to the greatest extent possible, private sector involvement;
- ensuring that risk transferred to the Commonwealth is appropriately priced and that the Commonwealth is compensated by those benefiting from the assistance;
- allowing the re-emergence of the commercial markets for terrorism risk cover; and
- global solutions.<sup>6</sup>

## Operation of the Bill

1.14 The Terrorism Insurance Bill provides that terrorism exclusion clauses in eligible insurance contracts are of no effect in relation to loss or liabilities arising from declared terrorist incidents. In effect this compels insurers offering such contracts to provide cover for terrorist risk.

1.15 The Bill establishes the framework for replacement terrorism insurance announced by the Treasurer on 25 October 2002. It also establishes a statutory authority – the Australian Reinsurance Pool Corporation (ARPC) – to provide reinsurance cover to insurers for losses arising from a declared terrorist incident and to manage the terrorism risk insurance scheme.

1.16 The scheme has compulsory application: eligible insurance contracts *must* provide terrorism cover. Insurers *may* reinsure this risk with the ARPC.

1.17 Only the basic framework of the scheme is contained in the Bill. Much of the detail will be contained in delegated legislation, in the form of directions from the Minister (the Treasurer) to the ARPC (clause 38) and in regulations (clause 43). Some of the detail of this delegated legislation is yet to be finalised. In considering the legislation the Committee has relied upon the proposed directions and regulations described in the explanatory memoranda to the Bill.

1.18 It is proposed that the scheme commence operation on 1 July 2003 and that the ARPC begin collecting premiums for reinsurance from 1 October 2003.

1.19 The engagement in the scheme of commercial insurers is intended to assist in the re-emergence of the commercial market for terrorism risk cover. Components of the scheme are stated to be deliberately flexible in order to encourage this re-emergence.

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<sup>6</sup> Revised Explanatory Memorandum, p. 6.

1.20 The Bill provides that the Minister must, at least once every 3 years, review the need for the scheme to continue. The Government has indicated that one of the key aims of such reviews will be to test the extent to which the commercial market for terrorist risk insurance is re-emerging.<sup>7</sup>

1.21 The Committee noted that the Bill does not specify the form of this review, nor whether any report from such a review must be tabled in the Parliament.

## **The report**

1.22 This report examines:

- The mechanism contained in the Bill to provide insurance for terrorist risk;
- The proposed model for insurance and reinsurance cover;
- The role and operations of the ARPC; and
- Administrative requirements.

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<sup>7</sup> *Revised Explanatory Memorandum*, p. 7.

## Chapter 2

### Insurance for terrorism risks

#### Overview

2.1 Part 2 of the Bill contains the mechanism by which insurance for terrorist risks is provided. Clause 6 defines the circumstances in which the Minister must declare that a terrorist incident has occurred. Loss or liability arising from a declared terrorist incident (except for loss arising from nuclear causes<sup>1</sup>) is defined as **eligible terrorist loss**. Clause 7 defines **eligible insurance contracts**. Clause 8 provides that a terrorist exclusion (however described) in an eligible insurance contract is of no effect in relation to eligible terrorist loss.

#### Declared terrorist incident

2.2 The Bill contains a definition of **terrorist act** (clause 5), which, for consistency, draws upon the meaning of the term in the *Criminal Code Act 1995*. The focus of that definition is an action done with the intention of advancing a political, religious or ideological cause with the intention of coercing, or influencing by intimidation, the government of the Commonwealth or a State, Territory or foreign country; or intimidating a section of the public.

2.3 Clause 6 sets out the circumstances in which the Minister, in consultation with the Attorney-General, must declare that a terrorist act constitutes a declared terrorist incident and therefore attracts the operation of the scheme. Although the Bill extends to things outside Australia (clause 4), one requirement is that the terrorist act must have happened in Australia (subclause 6(1)).

2.4 A terrorist act that is an act of war cannot constitute a declared terrorist incident for the purposes of the Bill (subclause 6(2)). The term ‘act of war’ is not defined in the Bill. Evidence from Treasury suggested that the distinction between terrorism and acts of war would be a legal question made with regard ‘to international definitions or accepted legal definitions and also to the advice of ... intelligence services.’<sup>2</sup> There is an established definition of ‘war’ in international law.<sup>3</sup>

#### Eligible insurance contracts

2.5 Clause 7 provides a starting point definition of **eligible insurance contracts**. This principally relates to loss of, or damage to, eligible property, business

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<sup>1</sup> Clause 3, definition of **eligible terrorist loss**. The Bill aims to restore access to the insurance that was available before 11 September 2001. Insurance for loss or liabilities arising from nuclear causes has not been available for many years.

<sup>2</sup> *Proof Committee Hansard*, p. 22.

<sup>3</sup> *Proof Committee Hansard*, p. 23.

interruption and associated public liability. The definition rests on the definition of *eligible property* in clause 3, principally buildings or other structures or works on, in or under land and tangible property located in or on such property.

2.6 The definition of eligible insurance contracts may be refined through regulations (subclause 7(2)). The revised explanatory memorandum (para 4.20) describes the range of insurance contracts that, under the regulations, will not be eligible. It is by this mechanism that the scheme will be restricted to contracts of insurance relating to commercial property.

2.7 The Committee notes that any changes to the coverage of the scheme effected by regulation would be subject to the normal procedures for the tabling and disallowance of regulations.

### **Statutory schemes**

2.8 Submissions from the Governments of New South Wales and Western Australia and from the Insurance Council of Australia call for the extension of the scheme to cover the privately underwritten statutory schemes in Australia.<sup>4</sup>

2.9 The explanatory memorandum indicates that:

The treatment of workers compensation and compulsory third party insurance schemes, and 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.<sup>5</sup>

2.10 The Committee notes that these discussions are continuing.<sup>6</sup>

### **State insurance**

2.11 The Western Australian Government also raises the case of its insurance arm, RiskCover, which is experiencing difficulty securing terrorism insurance. It suggests that protection could be achieved by having RiskCover reinsure through the terrorist risk insurance scheme, or by an arrangement between the States and the Commonwealth under which losses from terrorist acts are funded post-event according to an agreed formula.

2.12 The Committee notes that the proposal to reinsure State insurance not extending beyond the limits of the State concerned is specifically excluded by the Bill (subclause 7(3)), presumably for Constitutional reasons.<sup>7</sup>

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<sup>4</sup> Insurance Council of Australia, *Submission 8*, p. 2; Premier of New South Wales, *Submission 10*, pp. 2-3; Western Australian Department of the Premier and Cabinet, *Submission 11*, paragraph 3.2.

<sup>5</sup> *Revised Explanatory Memorandum*, p. 20.

<sup>6</sup> *Proof Committee Hansard*, p. 30.

## Places of worship

2.13 The Committee notes the approaches made to the Prime Minister by the NSW Premier, Mr Carr, regarding the cost and availability of insurance cover for places of worship. Although they are non-commercial entities, Mr Carr proposes that consideration be given to including them in the scheme. This could be achieved through the development of regulations refining the definition of eligible insurance contracts.

2.14 The Committee notes that Mr Carr's submission indicates that the Treasurer is considering the matter.<sup>8</sup>

## Coverage

2.15 As originally introduced into the House of Representatives, the Bill was to operate by deeming that eligible insurance contracts provided the same amount of insurance cover for eligible terrorism losses as for losses and liabilities from other causes, without regard to the underlying coverage in the insurance contract. This would have meant, for instance, that an eligible property would be deemed to be covered for flood damage caused by a declared terrorist incident regardless of whether the underlying insurance contract covered flood damage.<sup>9</sup>

2.16 Amendments to clause 8 moved by the Government and agreed to in the House altered this mechanism. The Bill now renders ineffective any purported exclusion of insurance cover for such loss. The effect of this is that terrorism risk insurance reflects the underlying insurance cover, providing policyholders with terrorism risk cover under the same heads of damage (eg: fire, flood, business interruption etc.) against which they otherwise choose to insure.

2.17 The operation of the mechanism now contained in clause 8 was explained as follows:

The whole scheme is intended purely to run off the back of what people commercially negotiate for losses other than those caused by terrorism. Prior to September 11, you had terrorism cover because there was no distinction between losses due to terrorism or any other loss covered under the contract. The industry then excised losses arising from terrorist events as defined, and that was driven very much by the major reinsurers. All this legislation does is nullify that exclusion. Everything else in the contract, therefore, is the same, and that determines your payment if it is a loss due to terrorism.<sup>10</sup>

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<sup>7</sup> Section 51(xiv) – the insurance power – is limited to ‘Insurance, other than State insurance; also State insurance extending beyond the limits of the State concerned’.

<sup>8</sup> Premier of New South Wales, *Submission 10*, pp. 2-3.

<sup>9</sup> See *Supplementary Explanatory Memorandum*, p. 3.

<sup>10</sup> Mr Murray Edwards, Manager, Market Access and Pricing Unit, Financial Systems Division, Department of the Treasury, *Proof Committee Hansard*, p. 27.

2.18 The Committee considers that this amendment adds certainty to the scheme by clarifying the scope of cover in a particular case.

### **Business interruption**

2.19 One of the features of the scheme is that contracts insuring against business interruption are included in the definition of eligible insurance contracts.

2.20 The submission from the Western Australian Government recommends that clause 7 of the Bill 'be clarified as to whether it captures consequential losses sustained by affected business in the downstream processes as a direct result of the act of terrorism'.<sup>11</sup>

2.21 Evidence from Treasury described the extent to which business interruption was covered by the scheme:

It is determined by the terms written into the underlying policy. All we are doing is piggybacking straight off the underlying commercial policy. So whatever the insurance company has commercially provided as business interruption cover [is included].<sup>12</sup>

2.22 Again, the Committee considers that this reliance on the underlying insurance contract provides certainty as to coverage.

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<sup>11</sup> Western Australian Department of the Premier and Cabinet, *Submission 11*, paragraph 4.

<sup>12</sup> Mr Murray Edwards, Manager, Market Access and Pricing Unit, Financial Systems Division, Department of the Treasury, *Proof Committee Hansard*, p. 27.

## Chapter 3

### The model

#### Overview

3.1 The Bill, together with foreshadowed directions and regulations, proposes a hybrid model, which has elements of both pre- and post-funding:

The Scheme involves the accumulation of a cash pool of \$300 million funded by premiums, backed by a commercial line of credit of \$1 billion and a Government indemnity of \$9 billion respectively. This is expected to provide a sufficient level of certainty and public confidence in coverage available against terrorist risk, with premiums more affordable than currently exist at market prices.<sup>1</sup>

3.2 The pre-funded element involves arrangements for the initial accumulation of funds for the \$300 million cash pool. The explanatory memorandum indicates that premiums to be paid by insurers to the ARPC under the scheme will initially vary between 2% and 12% of the underlying policy premium. This consists of a 2% base rate, with a 2% surcharge for contracts relating to urban property and a 10% surcharge for CBD property.<sup>2</sup>

3.3 The post-funded element involves arrangements to ‘top up’ the cash pool and ‘to repay any loan required in the event claims exceed the resources of the pool.’<sup>3</sup> In the event of a significant claim on the scheme, the premiums paid by insurers may be increased. The following table is indicative of the proposed premium structure.

TABLE 1: POSSIBLE PREMIUM STRUCTURE FOR REINSURANCE

Class of insurance	Initial rate (from 1 July 2003)	Maximum rate (after an event)
Commercial Property	2%	6%
- surcharge for CBD property	10%	30%
- surcharge for urban property	2%	6%
Public Liability	-	2%

Source: Revised Explanatory Memorandum, p 12

<sup>1</sup> Revised Explanatory Memorandum, p. 7.

<sup>2</sup> Revised Explanatory Memorandum, p. 12.

<sup>3</sup> Revised Explanatory Memorandum, p. 4.

3.4 The model has compulsory application: eligible insurance contracts *must* provide terrorism cover. As has been noted, this is achieved by nullifying the effect of any terrorism exclusion clause in such contracts.

3.5 Insurers *may* reinsure this risk with the ARPC but, in doing so, retain a part of that risk. The amount retained will be set by direction from the Minister to the ARPC, but is expected to be the lesser of \$1 million or 4% of gross Fire/ISR premium revenue per insurer per annum, and \$10 million across the industry per event.<sup>4</sup>

3.6 While there is broad support for Government intervention to address the absence of commercially available terrorist risk insurance, evidence before the Committee demonstrated a diverse range of views on the insurance model proposed in the Bill. Submissions varied on the questions of whether any insurance model was appropriate – effectively whether the scheme should involve pre-funding or be entirely post-funded – and whether the scheme should have compulsory application.

3.7 The Committee also took evidence on the premiums to be paid by insurers to the ARPC under the scheme, and the level at which insurers would pass these on to policyholders as premium increases.

### **An insurance scheme?**

3.8 The Insurance Australia Group (IAG) and the Council of Small Business Organisations of Australia (COSBOA) do not support the scheme, suggesting that the Government should ‘post-fund’ any loss arising from terrorist action, as it would respond to other national disasters. The IAG’s submission in particular argues against the implementation of an insurance model:

Insurance companies calculate the risks of events occurring and price cover accordingly. The premiums paid by large groups of people cover the losses incurred by small groups. This is the fundamental nature of insurance. However, the probability and severity of losses from a terrorism event are not calculable in advance and therefore unsuitable for insurance or, indeed, pre-funding.<sup>5</sup>

3.9 The submission points out the costs of administering such a scheme, including ‘the cost to insurers of necessary changes to systems and on-going compliance costs’, and concludes that the scheme represents ‘another impost on insurance which continues to reduce its affordability, impacting directly on non-insurance and under-insurance.’<sup>6</sup>

3.10 IAG instead proposes a ‘post-funded’ scheme: the Government providing funds in response to any terrorist event, with the costs subsequently borne by those affected, for instance through the imposition of a specific levy.

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<sup>4</sup> *Revised Explanatory Memorandum*, p. 155.

<sup>5</sup> Insurance Australia Group Ltd, *Submission 1*, p. 2.

<sup>6</sup> Insurance Australia Group Ltd, *Submission 1*, p. 2.



3.11 COSBOA concurs with the IAG's contention that the Government should provide relief after a terrorist incident:

There has been a near-unanimous response from our members that they do not feel that small business should be burdened with the cost of paying for terrorism insurance. The belief of our membership is that terrorist acts should be seen in a community context similar to a national disaster and that government should self-insure for such instances.<sup>7</sup>

3.12 The Western Australian Government also opposes a pre-funded scheme:

Post-event funding will avoid the negative consequences of a large, unallocated accumulation of funds that is a reality of pre-event funding. Post-event funding will also ensure that businesses are not burdened unnecessarily with another increase in premiums.<sup>8</sup>

3.13 On the other hand, the Committee received several submissions supporting the principle of a pre-funded scheme. The Australian Bankers' Association strongly supports a pre-funded model:

While a post-funded model has a few things going for it – you know exactly how much premium you need to collect after the event because you can assess the damage – a pre-funded model does have some advantages: it allows you to have a framework in place in case something happens, you can respond immediately, people know what to do, and a quick response clearly has some benefit in limiting the cost of exposure.<sup>9</sup>

3.14 The Property Council of Australia concurs, citing certainty as the key issue:

We are talking about an attack on assets which fundamentally are collateral for the finance system and it is because those physical assets are not covered that we have uncertainty. This scheme deals with that because a cover is in place and guaranteed by the federal government. Under a post-funded scheme you still do not have that.<sup>10</sup>

3.15 The Committee notes that the proposed model is a hybrid of pre- and post-funding arrangements. The ICA, among others, suggests that the pre-event funding – the pool of \$300 million – is 'quite insignificant' in the context of the overall

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<sup>7</sup> Mr Michael Potter, Chief Executive Officer, Council of Small Business Organisations of Australia Ltd, *Proof Committee Hansard*, p. 13.

<sup>8</sup> Western Australian Department of the Premier and Cabinet, *Submission 11*, paragraph 3.1.

<sup>9</sup> Ms Ardele Blignault, Director Government and Stakeholder Relations, Australian Bankers' Association, *Proof Committee Hansard*, p. 4.

<sup>10</sup> Mr Peter Verwer, Chief Executive Officer, Property Council of Australia, *Proof Committee Hansard*, p. 12.

scheme.<sup>11</sup> It is significant, however in ensuring that the scheme engages the private sector. According to Treasury, it provides:

... a ready pool of funds to apply to an event – it gives the added certainty that there is some cash there to apply – and it also means that those benefiting from the risk are making a contribution for that benefit. There is an argument to say that that might facilitate the market coming back more readily than a post-event funded type of arrangement.<sup>12</sup>

3.16 The Committee recognises that, where risk cannot be priced, a pre-funded insurance model is generally not appropriate. That is the very failure this scheme is designed to address. The Committee considers, however, that the hybrid nature of the proposed solution overcomes this obstacle. The pre-funded part of the scheme becomes viable because of the limits placed upon the exposure of the insurer. The pool arrangement, pre-event, will be limited to an accumulation of \$300 million. The exposure of individual insurers will be limited through retention arrangements.

3.17 These pre-funding arrangements are secured by the existence of the \$1 billion line of credit and the \$9 billion indemnity. Post-event exposure for insurers, though potentially involving an increase in premiums paid by insurers, will also be limited under the scheme.

3.18 The Committee considers that, by these measures, the Government has devised a model that is affordable and provides the requisite commercial certainty, while responding positively to the needs created by the failure of the terrorism insurance market.

### **A compulsory scheme?**

3.19 Related questions are whether the scheme should be compulsory and the definition of the class of businesses required to contribute to the scheme. According to the Government:

The compulsory application of the scheme is intended to allow accumulation of a credible funds pool within a reasonable period and to avoid problems of undiversified risks and uncertainty as to who will be eligible for compensation in the event of a terrorist act.<sup>13</sup>

... all classes of commercial property owners would be required to purchase insurance, whether or not they considered their property to be at risk from terrorism. This may attract criticism, especially in rural areas where the risks of terrorist attack will be perceived as being minimal. However, it is important to note that damage from terrorist attacks can in fact be incurred

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<sup>11</sup> Mr Alan Mason, Executive Director, Insurance Council of Australia, *Proof Committee Hansard*, p. 29.

<sup>12</sup> *Proof Committee Hansard*, p. 26.

<sup>13</sup> *Revised Explanatory Memorandum*, pp. 1-2.

quite remote from the centre of such attacks, for example, where energy or water infrastructure are targeted, interrupting the operation of business.<sup>14</sup>

3.20 Submissions were again divided on these issues, and a number of organisations referred to similar schemes operating overseas involving optional terrorism insurance.

3.21 ARIMA, the peak body of professional risk managers, provides a mixed response, reflecting the diversity of its member organisations. Members from petroleum, mining and manufacturing industries support the concept of the scheme but feel participation should be voluntary, whilst risk managers from the banking and property sectors support its compulsory application.<sup>15</sup> ARIMA submits that the top corporations do not believe they have a need for terrorism insurance:

The ability for those in need to source a form of financing is supported, but we have what will be a levy on corporate Australia and small-business Australia to finance, in our considered view, CBD exposures.<sup>16</sup>

3.22 COSBOA also expressed its concern that the scheme imposes a compulsory levy on small business for what is effectively a threat against large CBD properties.<sup>17</sup>

3.23 The Insurance Council of Australia, Royal & Sun Alliance (R&SA), the Australian Bankers' Association and the Property Council of Australia support the compulsory application of the scheme. The ABA, for example, submitted that:

Uninsured exposure potentially impacts all Australians because of the underlying retail investments in these projects through property trusts and superannuation fund membership. As all Australians are potentially affected it is important that the scheme be compulsory. The compulsory nature of the scheme is also essential to its viability by ensuring that premiums are set at a reasonable cost for insureds.<sup>18</sup>

3.24 To emphasise the extent to which property investment by superannuation funds has become the acme of collective ownership in Australia, Mr Verwer, CEO of the Property Council, was moved to report:

'If Karl Marx were alive today, he would be a superannuation fund manager.'<sup>19</sup>

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<sup>14</sup> *Revised Explanatory Memorandum*, p. 10.

<sup>15</sup> Association of Risk and Insurance Managers of Australasia Ltd, *Submission 2*, p. 2.

<sup>16</sup> Mr Kevin Mutch, Honorary Life Member, Past President and Member, Association of Risk and Insurance Managers of Australasia, *Proof Committee Hansard*, pp. 5-6.

<sup>17</sup> *Proof Committee Hansard*, p. 14.

<sup>18</sup> Australian Bankers' Association, *Submission 4*, pp. 2-3.

<sup>19</sup> *Proof Committee Hansard*, p. 8.

3.25 The Property Council concludes that, as 70% of CBD property in Australia is owned ‘by ordinary Australians’ through superannuation funds, protecting it is a matter for everyone, not just ‘the big end of town’.<sup>20</sup>

3.26 There is also a contention that small business is equally in need of coverage as the tenants of CBD properties:

If there were an attack—and a chemical or biological attack is probably the most likely—whole blocks would be taken out and those who would suffer most, who would get no recompense under the current system or schemes, are all of the tenants, the small businesses. There would be massive business interruption there and they would be in courts for a decade trying to get any money out of the owner.<sup>21</sup>

3.27 The ICA concurs, arguing that in the event of an attack on CBD property loss would extend well beyond the target buildings, encompassing all the business infrastructure, suppliers and customers.<sup>22</sup>

3.28 The differentiation of premium costs with reference to location<sup>23</sup> recognises that different organisations face different levels of risk and is cited as injecting a measure of equity:

While compulsory, the differential in premiums reflects the degree of risk, with higher risk classes such as CBD assets paying a higher premium.<sup>24</sup>

3.29 The Property Council notes that the scheme ‘is quite good at allocating risks to different players and charging a levy based on that risk.’<sup>25</sup> The effect of this is that the businesses which are at lesser risk have that risk reflected in two ways: ‘by the fact that it is only a two per cent surcharge and, second, it is two per cent on a very small number.’<sup>26</sup>

3.30 The Government has argued that it has very strong advice that such a scheme could not work without compulsion in the Australian context, because of the relatively small size of the market, and problems associated with adverse risk selection.<sup>27</sup>

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<sup>20</sup> Property Council of Australia, *Submission 6*, p. 4.

<sup>21</sup> Mr Peter Verwer, Chief Executive Officer, Property Council of Australia, *Proof Committee Hansard*, p. 11.

<sup>22</sup> Mr Alan Mason, Executive Director, Insurance Council of Australia, *Proof Committee Hansard*, pp. 28-9.

<sup>23</sup> The explanatory memorandum indicates that premiums to be paid by insurers to the ARPC under the scheme will initially vary between 2% and 12% of the underlying policy premium. This consists of a 2% base rate, with a 2% surcharge for contracts relating to urban property and a 10% surcharge for CBD property – *Revised Explanatory Memorandum*, p. 12.

<sup>24</sup> Australian Bankers’ Association, *Submission 4*, p. 3.

<sup>25</sup> *Proof Committee Hansard*, p. 11.

<sup>26</sup> *Proof Committee Hansard*, p. 12.

<sup>27</sup> *Proof Committee Hansard*, p. 16.

3.31 The Insurance Council of Australia supports this argument:

If you had adverse risk selection, it would be only those people who would think themselves as being most at risk who would seek to buy the cover, who are the very people who need it. If the full cost of their exposure were to be charged to them, they would not be able to secure the cover anyway.<sup>28</sup>

3.32 The Committee accepts the view that the compulsory application of the scheme is necessary to provide a credible pool of funds within a reasonable period of time and provides the benefits of simplicity of administration.

3.33 The Bill operates by nullifying terrorism exclusion clauses – ‘piggybacking’, as it has been put, on the underlying insurance coverage. This gives policyholders the opportunity to insure against all risks that were available prior to 11 September 2001. Although this will entail increased costs for policyholders, it is evident that this approach will provide terrorist insurance cover which is both significantly cheaper and more comprehensive than the cover that is now commercially available. In this regard the Committee also supports the differentiation of premium price, approximating an assessment of relative risk, as a measure injecting equity into the scheme.

3.34 The Committee also notes that the scheme attaches to contracts of insurance covering commercial property. Entities that do not seek to insure their properties, or that self-insure, are not covered by the scheme and do not have to make any payments under it.

## **Price control**

3.35 Premiums will be paid by insurers to the ARPC to fund the reinsurance pool. These are set by direction from the Minister to the ARPC and are initially expected to be between 2 and 12 percent of the underlying premium, depending on the location of the insured property.

3.36 A number of submissions have noted that, as well as the premiums paid to the ARPC, insurers will have administrative overheads to recover, and that stamp duty, fire levies and taxes will have to be applied, creating a multiplier effect. Royal & Sun Alliance Insurance points out that the cost of premium increases will also have to be grossed up to include the commissions of insurance intermediaries.<sup>29</sup> ARIMA summarised its view of the likely effect on premium increases to policyholders:

We believe that the premiums will, depending on the rate struck, potentially exceed expectations behind the architects of this particular piece.

... We are concerned that stamp duty and fire brigade levies, which go up to as high 80 per cent in certain states, are attached to insurance premiums. For every dollar in premium there is in addition of up to 80 cents in stamp duty,

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<sup>28</sup> Mr Alan Mason, Executive Director, Insurance Council of Australia, *Proof Committee Hansard*, p. 28.

<sup>29</sup> Royal & Sun Alliance Insurance Australia Limited (R&SAIAL), *Submission 9*, p. 2.

the fire brigade levy and GST. So it does magnify the impact on corporate Australia.<sup>30</sup>

3.37 There is no mechanism, however, to regulate the level at which the premiums set for insurers are passed on as premium increases to policyholders. COSBOA has expressed particular concern about the possibility of insurers profiteering from the scheme:

The other major concern is that the indicative rates that would be charged ... suggest this is the premium rate that insurance companies would have to pay to the Australian Reinsurance Pool Corporation. It does not cap the costs that an insurance company could charge a commercial property or on the surcharge for CBD and urban properties.<sup>31</sup>

3.38 Parallels have been drawn with the requirement that APRA issue guidelines on 'reasonable' increases in premiums under the Medical Indemnity (Prudential Supervision and Product Standards) Act 2002 and the oversight role of the ACCC in the introduction of the GST. Evidence from Treasury indicated that the Government had not considered such approaches for this scheme.<sup>32</sup>

3.39 The Property Council considers that 'there is merit in exploring means to ensure that there is no exploitation of this scheme by insurance companies'.<sup>33</sup> In its supplementary submission the Property Council indicates that it supports a role for the ACCC in the avoidance of price exploitation:

Realising that domestic price signals would be dampened under the ARPC model, the Property Council supports the drafting of regulations for ACCC monitoring of the ARPC market for terrorism insurance.<sup>34</sup>

3.40 The Government has indicated that it proposes to explore possible acceptable cost-recovery arrangements for insurers, but expresses an expectation that market forces will ensure that premiums charged to policyholders do not significantly exceed charges for reinsurance.<sup>35</sup> At the hearing, Treasury indicated that such arrangements had not yet been explored and expressed confidence in the ability of the market to provide sufficient competitive pressure:

This scheme piggybacks on commercial contracts, and so there is competitiveness out there in terms of people writing commercial contracts for insuring buildings for risks other than terrorism now – there is a very

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<sup>30</sup> Mr Kevin Mutch, Honorary Life Member, Past President and Member, Association of Risk and Insurance Managers of Australasia, *Proof Committee Hansard*, p. 7.

<sup>31</sup> Council of Small Business Organisations of Australia Ltd (COSBOA), *Submission 5*, p. 1.

<sup>32</sup> Mr Murray Edwards, Manager, Market Access and Pricing Unit, Financial Systems Division, Department of the Treasury, *Proof Committee Hansard*, p. 19.

<sup>33</sup> Mr Peter Verwer, Chief Executive Officer, Property Council of Australia, *Proof Committee Hansard*, p. 12.

<sup>34</sup> Property Council of Australia, *Supplementary submission 6a*, p. 5.

<sup>35</sup> *Revised Explanatory Memorandum*, p. 48.

competitive market in that. All this will do this excise the terrorism carve-outs of those contracts. So at the base level there is quite a strong competitive market environment.<sup>36</sup>

3.41 The Insurance Council concurs:

At the end of the day, it is a competitive insurance market. The terrorism cover is being added to policies that companies have already sold and seek to sell, so the companies clearly have an interest in remaining competitive in the business they are doing, because the whole of the client's policy or portfolio is what they are interested in. I expect that competitive market forces will continue to operate.<sup>37</sup>

3.42 The Committee accepts the evidence that market forces can be expected to contain premium increases as a result of the implementation of the scheme. The Committee considers, however, that the matter of appropriate cost-recovery arrangements should be one of the areas examined in the periodic review of the scheme under clause 41 of the Bill.

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<sup>36</sup> Mr Murray Edwards, Manager, Market Access and Pricing Unit, Financial Systems Division, Department of the Treasury, *Proof Committee Hansard*, p. 17.

<sup>37</sup> Mr Alan Mason, Executive Director, Insurance Council of Australia, *Proof Committee Hansard*, p. 31.





## Chapter 4

### Australian Reinsurance Pool Corporation

#### Establishment, functions and powers

4.1 Part 3 of the Bill establishes the Australian Reinsurance Pool Corporation (ARPC), sets out its powers and functions, and makes provision relating to the appointment of its chair and members and a full-time chief executive.

4.2 The ARPC is established by clause 9. Its functions are to provide insurance cover for eligible terrorism losses and such other functions as may be prescribed by regulations (clause 10). It will have the power to charge premiums in respect of contracts of insurance and to charge fees for service (clause 11).

4.3 The ARPC will be a statutory corporation and consist of the Chair and at least four, but not more than six, other members (clause 12).

#### Directions

4.4 The operation of the scheme is dependent on directions from the Minister to the ARPC (clause 38). Such directions can require the ARPC to pay money to the Commonwealth, set premiums to be charged for insurance contracts issued by the ARPC and set out the extent to which risk is to be retained by the insurer under a contract of reinsurance. There is a requirement that directions on premiums and retention levels be published (subclause 38(6)).

4.5 The Committee notes that there is no requirement in the Bill that directions made under clause 38 be tabled in the Parliament and they are not disallowable instruments.<sup>1</sup>

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<sup>1</sup> *Proof Committee Hansard*, p. 20.



## Chapter 5

### Administrative requirements

5.1 As has been noted, much of the administrative detail of the scheme will be set out in directions from the Treasurer to the ARPC and in regulations.

5.2 Submissions from the insurance industry raised concerns about administrative difficulties faced by insurers in implementing the scheme. The three main concerns related to the timeframe within which changes would have to be made, the cost of making these changes, and uncertainty as to what would be contained in the directions and regulations.<sup>1</sup>

5.3 Royal & Sun Alliance Insurance Australia (R&SA) estimates that the permanent system changes the scheme requires will cost the company between \$1m and \$1.5m. The R&SA submission also noted that, to meet deadlines in the scheme, temporary measures would need to be taken, in conjunction with preparing permanent system changes.<sup>2</sup> The Insurance Council of Australia also noted the concerns of its members about making such system changes in time:

The changes will have to be incorporated in insurance company renewal notices, which are sent out prior to 1 October. In fact, they will be going out in early to mid-August. That means they have to have their systems totally tested and in place by the end of July. Given that the bill has not even passed yet, we do not have regulations yet and there are many more unanswered questions to deal with, our members are quite concerned about whether they will have enough time to have all this in place, fully tested and up and running, by the end of July.<sup>3</sup>

5.4 Submissions raised concerns about the lack of final detail in administrative matters such as the definition of ‘eligible insurance contract’<sup>4</sup>, how the different categories of property type would be classified (ie CBD, urban, and rural),<sup>5</sup> what type of data the ARPC would require, and whether or not the \$1 million maximum exposure retained by insurers under the scheme would affect APRA solvency

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<sup>1</sup> Insurance Council of Australia Ltd, *Submission 8*, p 2; Royal & Sun Alliance Insurance Australia Ltd, *Submission 9*, pp. 1-2.

<sup>2</sup> Royal & Sun Alliance Insurance Australia Ltd, *Submission 9*, pp. 1-2.

<sup>3</sup> Mr Peter Anderson, Manager, Policy, Insurance Council of Australia, *Proof Committee Hansard*, p. 30.

<sup>4</sup> Insurance Council of Australia Ltd, *Submission 8*, p. 2.

<sup>5</sup> Royal & Sun Alliance Insurance Australia Ltd, *Submission 9*, p. 2.

requirements.<sup>6</sup> The Insurance Council of Australia confirmed that these concerns were being addressed in consultations with Treasury.<sup>7</sup>

5.5 The Committee appreciates that insurers need specific detail regarding the operation of the Bill, including administrative matters to be specified in the regulations and directions that will be made under the legislation. The Committee recommends that, to assist the insurance industry in making the necessary administrative changes, the relevant regulations and directions be published, in draft form, as soon as possible.

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<sup>6</sup> Royal & Sun Alliance Insurance Australia Ltd, *Submission 9*, pp. 2-3.

<sup>7</sup> Mr John Morgan, Legal Adviser to Insurance Council of Australia, Allens Arthur Robinson, *Proof Committee Hansard*, p. 30.

## Chapter 6

### Conclusion and recommendations

#### Conclusion

6.1 The Committee supports the scheme as it has been proposed in the Terrorism Insurance Bill 2003, as amended in the House of Representative and supports the detail of the associated delegated legislation as outlined in the Revised Explanatory Memorandum.

#### Recommendations

6.2 The Committee makes the following recommendations.

1. **That the Bill be passed.**
2. **That, to assist the insurance industry in making the necessary administrative changes, the relevant regulations and directions be published, in draft form, as soon as possible.**

Senator George Brandis  
**Chair**



## ADDITIONAL COMMENTS BY LABOR SENATORS

The Terrorism Insurance Bill 2003 seeks to implement a scheme to address market failure in the insurance industry. The lack of commercial terrorism cover is a problem in many western countries. In the United States, Britain, Germany, Spain, France and Austria schemes have been established to provide Government reinsurance. Labor Senators accept the evidence provided to the Committee that while the market is providing some terrorism cover, it is very expensive and narrow in scope. The lack of cover has the potential to jeopardise the financing of major projects and leaves financial institutions and commercial property owners exposed to large losses in the event of a terrorist attack. All witnesses agreed that there was a need for Government intervention to ensure that cover was available for those entities that required it. Debate before the Committee focused on the question whether the proposed scheme is the best way of dealing with the problem.

### Post-funded Model

The Government's scheme has been described as a 'hybrid'.<sup>1</sup> It involves 'pre-funding' the reinsurance pool to \$300 million through premium income. If a terrorist incident exhausts the resources of the pool up to \$10 billion is available through a loan and government indemnity. These amounts can be recovered through increased premiums after a terrorist attack.

As the Chair's report notes the Committee received submissions from the Insurance Australia Group, the Western Australian Department of the Premier and Cabinet and the Council of Small Business Organisations of Australia that supported a post-funded model. Under such an approach a levy would be imposed on insurance premiums or taxpayers generally after a terrorist event.

A post-funded scheme already operates under superannuation legislation where a levy may be imposed on superannuation funds if a fund suffers substantial losses as a result of fraudulent conduct or theft.<sup>2</sup> Labor Senators also note that the HIH Royal Commission recommended a post-funded model to protect depositors in the event of an insurance company failure.<sup>3</sup>

Labor Senators believe a post-funded scheme is an attractive alternative to the Government's scheme and are concerned that the option was not fully explored in the consultation process.

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<sup>1</sup> Explanatory Memorandum p. 6.

<sup>2</sup> *Supervision Industry (Supervision) Act 1993* (section 227). Section 8 of the *Superannuation (Financial Assistance Funding) Levy Act 1993* permits the Minister to levy superannuation funds up to 0.05% of fund assets to provide assistance to another eligible superannuation fund.

<sup>3</sup> Recommendation 61 HIH Royal Commission Vol 1 p. 301.

Key advantages of a post-funded model include that: the community does not incur any cost if there is not a terrorist incident; it avoids the administrative costs of establishing the scheme; and, in the event that an incident occurs, the amount of money that needs to be collected is certain.

Supporters of the Government's hybrid scheme argue that it provides business with greater certainty and ensures that funds can quickly be paid out in the event of a terrorist incident. Undoubtedly a major factor for supporters of the Bill is also their desire to see a scheme in place quickly. There has been little work done on a post-funded scheme. A decision to opt for such a scheme would involve the rejection of this Bill and a lengthy delay in the development of a new proposal.

In recognition of the immediate risks being faced by financial institutions and commercial property owners Labor Senators accept that the proposed hybrid scheme should be supported at present. In Government however Labor would review the operation of scheme and give detailed consideration to putting in place a post-funded model.

## **Premiums**

Insurers indicated that they intend to charge premiums in excess of the cost of reinsurance in order to recover 'administrative and other costs'. COSBOA and the Property Council expressed concern that the Bill provides no limit on the terrorism insurance premiums that may be charged by insurers. Both groups supported a role for the ACCC in preventing price exploitation.

Despite the fact that the Government 'pledged to explore possible acceptable cost recovery arrangements for insurers in regard to reinsurance premiums charged by the scheme'<sup>4</sup> Treasury officers informed the Committee that no such work had been undertaken.<sup>5</sup> Instead the Government asserted a faith in competitive forces in the insurance market to ensure that insurance companies do not use the fact that policyholders will be required to take out terrorism cover to dramatically increase premiums.

Labor Senators do not share this confidence in the effectiveness of competition in the industry. Recent experience in relation to public liability insurance demonstrates that the industry is far from competitive. Despite substantial and continuing tort law reforms made by State and Territory governments, public liability premiums continue to rise. We are yet to see any of the promised savings being passed on to consumers.

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<sup>4</sup> Revised Explanatory Memorandum, p.12.

<sup>5</sup> Mr Murray Edwards, Manager, Market Access and Pricing Unit, Financial Systems Division, Department of the Treasury. Proof Committee Hansard, p.17.



Labor Senators are also mindful of the recent experience in the United States where massive premium increases followed the introduction of a reinsurance scheme which requires insurers to offer terrorism cover.<sup>6</sup>

Labor Senators recommend that the Bill be amended to empower the ACCC to prevent price exploitation in relation to the introduction of compulsory terrorism cover for eligible insurance contracts.

## **Compulsion**

The Committee heard evidence from COSBOA and ARIMA opposing the fact that the policyholders are required to take out cover. They argued that it effectively required those at low risk or those who were prepared to accept the risk to subsidise those who wanted terrorism cover.

## **Review**

Labor Senators concur with the discussion in the Chair's report that in order for this scheme to operate effectively compulsion is a necessary element. Labor will seek to address the concerns of small business by empowering the ACCC to prevent price exploitation in relation to terrorism cover.

Clause 41 of the Bill provides that the Minister is to review the need for the operation of the scheme every three years. Labor Senators are concerned that the Bill does not presently contain any requirement that the report resulting from the review be tabled in the Parliament or otherwise made publicly available. Labor will move amendments to the Bill in the Senate to ensure that reviews of the scheme are subject to public scrutiny.

## **Recommendation**

Labor Senators recommend that the Bill be amended:

**to empower the ACCC to prevent price exploitation in relation to terrorism insurance and**

**to require the Government to table reports reviewing the operation of the scheme every three years.**

SENATOR JACINTA COLLINS  
Labor Senator For Victoria

SENATOR RUTH WEBBER  
Labor Senator for Western Australia

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<sup>6</sup> David Plump and Helen Stock, 'Owners reject terror cover as costs soar' *Australian Financial Review*, 27 February 2003.



# Appendix 1

## Submissions Received

<b>Submission Number</b>	<b>Submittor</b>
1	Insurance Australia Group Ltd
2	ARIMA Ltd
3	Australian Industry Group
4	Australian Banker's Association
5	Council of Small Business Organisations of Australia Ltd (COSBOA)
5a	Council of Small Business Organisations of Australia Ltd (COSBOA)
6	Property Council of Australia
6a	Property Council of Australia
7	Law Council of Australia
8	Insurance Council of Australia
9	Royal & Sun Alliance Insurance Australia Limited (R&SAIAL)
10	Government of New South South Wales
11	The Western Australian Department of the Premier and Cabinet
12	Queensland Government

# **Appendix 2**

## **Public hearing and witnesses**

**Thursday, 1 May 2003 - Canberra**

**Australian Bankers' Association**

Ms Ardele Blignault – Director

**ARIMA Ltd (Association of Risk and Insurance Managers of Australasia)**

Mr Kevin Mutch, Honorary Life Member, Past President and Member

**Property Council of Australia**

Mr Peter Verwer, Chief Executive Officer

Mr Michael Zorbas, Chief Advocate

**Council of Small Business Organisations**

Mr Mike Potter, Chief Executive Officer

**Insurance Council of Australia (Video Conference)**

Mr Alan Mason, Executive Director

Mr Philip Maguire, Deputy Chief Executive

Mr Peter Anderson, Manager, Policy

Mr John Morgan, Legal Adviser, Allens Arthur Robinson

**Department of the Treasury**

Mr Murray Edwards, Manager, Market Access and Pricing Unit, Financial Systems Division

Mrs Penny Sirault, Policy Adviser, Market Access and Pricing Unit, Financial Systems Division

