



INTERNATIONAL CONFERENCE ON AIR LAW

(Montréal, 20 April to 2 May 2009)

IMPACT OF THE PROPOSED UNLAWFUL INTERFERENCE CONVENTION (ICAO DCCD Doc No. 3) ON AVIATION INSURANCE

(Presented by the International Union of Aerospace Insurers)

1. INTRODUCTION

1.1 Annex A is a guide to aviation insurance which was written in 2004 for the benefit of government officials who were new to the subject. This has been updated to 2009 to reflect developments in the aviation insurance market.

1.2 Annex B is a table comparing the actual insurance outcomes of 9/11 with those of the current unlawful interference draft (DCCD Doc No. 3), had it been in force at that time, and also with those outcomes if DCCD Doc No. 3, as amended by the Joint Industry Position Paper, had been in force at the time.

2. IMPACT ON INSURANCE

2.1 The declared purpose of the modernization of the Rome Convention 1952 is to bring certainty to the compensation of third-party victims. This certainty brings two additional benefits: the need for costly and lengthy litigation is much reduced; and insurers can more accurately quantify their exposures, with consequent potential benefits for all parties.

2.2 The reverse, of course, is true. The fragile cap as envisaged in DCCD Doc No. 3 introduces great uncertainty. The inclusion of servants and agents will inevitably lead to lengthy and costly litigation which will delay payments to victims while increasing insurers' and operators' costs. Currently, third-party war risk cover is not fully integrated into airline 'all risks' policies, and excess layers to supplement the basic cover are purchased in the specialized 'war risks' market. A cap which could be broken would not bring the benefits originally envisaged by the protocol and would likely therefore be substantially ignored by insurers and reinsurers.

APPENDIX A

A GUIDE TO AVIATION INSURANCE

1. BACKGROUND

1.1 The underlying principle of traditional insurance markets is that the premiums of the many pay for the losses of the few. The aviation insurance market has always differed from most other insurance markets in that both the premium base and the customer base are very narrow, with just a small number of insureds: this is highlighted by the fact that IATA has only some 220 airline members. At the same time, the potential exposure of each airline is huge. Because of this very large exposure it is almost unknown for a single insurer to underwrite the entire amount of an airline's overall risk. Usually, a number of insurers will each underwrite a small percentage of that exposure, thus keeping the exposure for any one insurer within acceptable limits.

1.2 Aviation insurers provide insurance cover for insureds (airlines, manufacturers, airports, service providers {refuellers, caterers, security screeners and the like}) against loss, damage and liability, in return for premiums. Insurers in turn pay premiums to reinsurers to offset part of the risk. The risk that an insurer can prudently cover is determined by the sum of: funds from his capital providers; retained profits; and any reinsurance he has purchased.

1.3 The principal insurance coverages, all of which exclude war risks (through exclusion clause AVN48B), are:

- a) hull – damage to the aircraft itself;
- b) passenger – liability for death or injury; and
- c) third party – liability for death and bodily injury (BI) and property damage (PD) external to the aircraft.

1.4 War risks coverages (“war, hijacking and other perils” including terrorism) are:

- a) hull – insured in a separate war risk insurance market; and
- b) passenger and third party – added to the principal liability policies by an extension clause known as AVN52. This cover (with limits as high as US\$2bn for each and every occurrence for each insured) was traditionally provided at nominal cost, given the absence of major loss.

1.5 War risk coverages have traditionally contained a seven-day notice clause which allowed insurers to review and reassess the risk and, if necessary, amend or cancel the cover in the event of a radical and adverse change in conditions or circumstances, such as occurred on 11 September 2001.

1.6 From 1998 to 2000, hull, passenger, and third-party claims exceeded premiums by some US\$2.75bn in the airline sector alone. Because of the unprofitable nature of the airline insurance industry, its capacity was already severely diminished prior to 11 September 2001, and premiums were rising, albeit slowly. In the decade to 2001, there were only four years where market premium exceeded incurred claims, and for that ten years as a whole claims exceeded premiums by US\$13,069m.

2. 11 SEPTEMBER 2001 AND THE IMMEDIATE AFTERMATH

2.1 The terrorist attacks were an unprecedented event with losses on a scale never before contemplated by governments or the insurance industry, far exceeding previous manmade or natural catastrophes such as Hurricane Andrew. The possibility of further occurrences anywhere in the world, particularly arising out of the use of aircraft to cause third-party damage, posed a problem for insurers. The need to preserve their solvency, with reserves already severely depleted, and now under pressure from their capital providers and reinsurers (in turn under pressure from *their* capital providers) forced the market to control its exposure to risk. The fundamental problem was the unquantifiable nature of the new third-party risk: if a risk cannot be quantified then it cannot be sensibly priced.

2.2 Consequently, and after considerable deliberation, insurers invoked the cancellation provision for all war risk cover on 17 September 2001, to take effect seven days later. This was the first time that blanket worldwide notice had been given: it should be noted that *non-war* hull, passenger and third-party covers were unaffected. In addition, it is important to understand that notice of cancellation was not issued until insureds had been notified of the revised basis of cover that was on offer: at no stage were insureds left without an offer of cover of some description¹. Following review, war risk cover was then provided for airlines as follows:

- a) full policy limits for passenger liability arising out of war risks; and
- b) cover limited to a maximum of US\$50m for all third-party BI and PD claims during any one 12-month policy period.

2.3 In order to regain the confidence of the capital providers, and to ensure that the necessary capacity would continue to be available in spite of the paralysis of the market in the aftermath of the US attacks, an additional premium of US\$1.25 per passenger carried was introduced as a result of discussions between insurers and the airlines' representatives, the brokers. As airlines renewed their cover in 2002 the airline insurance market gradually eased the level of surcharge for passenger and third-party liability cover within airline policies, but third-party war risk cover remained limited to US\$50m. Significant premium reductions were granted later in 2002 and this continued into 2004. By the third quarter of 2002 the \$1.25 element did not feature in the vast majority of renewals.

2.4 Eventually, the US\$50m cover was also made available to airports and service providers, although some airport security screeners were still unable to purchase cover due to the extent of the potential liability arising from the critical nature of their role.

¹ As a result of this, the Aviation Insurance Clauses Group (AICG) was established by the Lloyd's Market Association and the International Underwriting Association of London. The AICG establishes, in consultation with users, non-binding standard wordings for use in aviation insurance policies.

3. SUBSEQUENT DEVELOPMENTS

3.1 Additional capacity was deployed by certain commercial insurers separately from the basic hull and passenger liability policies, offering further cover in two layers from US\$50m to US\$150m and from US\$150m to US\$1bn. The second layer was at first not made available to airports and service providers. Cover for both layers initially cost a total of US\$1.85 per passenger carried, which was in addition to the US\$1.25 charge referred to above. These charges were levied equally on every airline insured, because the 11 September losses were seen as affecting the airline industry in general rather than only the two airlines directly involved.

3.2 After a few months, the US\$1.85 excess charge became negotiable based upon the risk profile of individual airline insureds and a steady increase in the supply of capacity, and hence competition, caused premium rates to fall considerably. Coverage could then be negotiated for less than US\$0.70 per passenger carried. In addition, airports and service providers and even airport security screeners could obtain cover up to a total limit of US\$1bn or more in some cases.

3.3 The position at March 2004 was that Airlines could generally chose between three types of coverage:

- a) non-cancellable policies, which additionally provided cover for passenger liability in the event of the cancellation of the passenger war coverage under the airline main hull & liability policies (similar to the “drop down” provision envisaged in the Globaltime scheme);
- b) policies which were subject to cancellation only after four major events; and
- c) policies which had a 30 day cancellation provision.

3.4 Whilst most airlines had been purchasing limits of \$1 billion or less, by March 2004 several were buying higher limits, up to \$2 billion any one occurrence.

4. REINSURERS AND THE US\$50M LIMIT

4.1 Many reinsurance programmes renew annually on 1 January, and it was anticipated at the end of 2001 that the basic US\$50m limit might be increased as a result. Instead, reinsurers generally applied this same limit to the policies they issued to insurers. As at March 2004, there appeared to be no immediate prospect of reinsurers generally being willing to give unlimited terrorist coverage, but individual reinsurers were willing to negotiate higher limits than the basic \$50m.

5. THE FUTURE (AS ENVISAGED IN MARCH 2004)

5.1 Some insurers have been and are willing to quote higher than US\$50m for third-party war liability within the main hull and liability policy in spite of the fact that the most reinsurers have not softened their stance on this. A number of major airlines have purchased cover with at least part of the placement carrying a \$150M limit. This trend looks set to continue.

5.2 It is possible that any further aviation-related terrorist attacks may result once again in the invocation of the seven- or 30-day notice periods, on those policies which still have a cancellation provision. However, now that war third-party policy limits are being better managed by the insurance industry, this need not necessarily follow. Furthermore, if the market is able to establish a sound premium base, then this would make the invocation of the notice period even less likely.

6. SUMMARY (AS AT MARCH 2004)

6.1 The aviation insurance market continues to provide cover at pre-11 September levels for all conventional, non-war risks.

6.2 Full war risk cover remains in place for hulls and passenger liabilities.

6.3 Because of the unprecedented extent of exposure revealed on 11 September, commercial insurance cover for passenger and third-party BI and PD war risks now costs more.

6.4 Options exist in the commercial market to purchase separate policies to increase the US\$50m third-party limit to US\$1bn for service providers and manufacturers and up to US\$2bn for airlines. This is in addition to the US\$1.5bn to US\$2bn that continues to be available for passenger liabilities.

6.5 Third-party war risk covers made available by various individual providers are unlikely to change significantly in the short term.

6.6 It is important to understand that the aviation insurance market is a free market, and the precise details of each war risks insurance policy will vary according to the individual insurer's view of the market and the risk profile of the particular insured. It is probable that the range of policies available will widen with time.

7. FOOTNOTE

7.1 The position as at March 2009 can be summarized as follows:

- a) full war risks cover remains available for hulls and passenger liabilities. With the advent of the A380 a number of carriers now buy limits of USD2.25 billion;
- b) new versions of the write-back clauses for liabilities which restrict the cover available for chemical and biological risks have been published but are not generally being used;
- c) cover for third-party BI and PD risks is still not fully integrated within the main "all risks" policies, other than for General Aviation risks. Airlines, Airports and Service Providers still commonly purchase excess layers to supplement the cover included in their basic policies;
- d) the most common sub-limit for third-party war is \$150m, although higher sub-limits are readily available;

- e) by and large cover for significant limits of third-party war is available only with an aggregate policy limit (although this may be a multiple of the per occurrence limit); and
- f) pricing for this type of cover has continued to fall and for airlines it is now less than one tenth of the cost seen in the immediate aftermath of 9/11.

APPENDIX B

INSURANCE OUTCOMES OF THE PROPOSED UNLAWFUL INTERFERENCE CONVENTION (ICAO DCCD Doc No. 3)

	Actual impact of 9/11	Impact if current RC draft (DCCD Doc No. 3) in force at 9/11	Impact if proposed Joint Industry amendments in force at 9/11
Article 3 Mental Injury	Majority of claims settled through the Victim's Compensation Fund, set up by US Govt post-911. Without VCF airlines and other actors would have been exposed. Other claims litigated within policy limits of airlines and other actors.	Included. Will increase claims quantum with downstream impact on insurance costs.	Not included – no impact on claims quantum.
Property Damage	Property owners/insurers pursuing aviation insureds through the courts for amounts in excess of total aviation insurance policy limits.	Included. Will increase claims quantum with downstream impact on insurance costs.	Not included – no impact on claims quantum.
Nuclear Damage	Not applicable.	Included but <i>uninsurable</i> and would quickly overtake liability limits.	Not included – no impact on claims quantum.
Article 23 Additional Compensation – servants and agents	The US Govt capped the operators' liability at their insurance limits through the Aviation Stabilisation act, otherwise potential claims on the operators would have been a significant multiple of their available insurance cover Potentially included by contract where rights have been assumed by operators.	Included. Safe harbour provision does not cover unlawful interference by servants or agents. Cap severely weakened, potentially increasing claims quantum with downstream impact on insurance costs.	Not included – no impact on claims quantum.
Article 24 Operator's right of recourse	Applicable – although what actually happened was that every potentially responsible party was sued, including for example foreign airlines and manufacturers. Plaintiffs' lawyers will pursue any entity where they see a deep pocket.	Applicable but delayed until victims settled. Limitations as to fault and as to insurance available to industry third parties.	Applicable but delayed until victims settled. Limitations as to fault and as to insurance available to industry third parties.

	Actual impact of 9/11	Impact if current RC draft (DCCD Doc No. 3) in force at 9/11	Impact if proposed Joint Industry amendments in force at 9/11
Article 25 SCM's right of recourse	Not applicable.	Included depending on degree of operator's fault.	Higher degree of operator's fault required.
Overall impact	Aviation insurance market loss still unquantifiable and industry uninsured loss still unquantifiable	Nullifies insurance protection purchased by operator: 1. Severely weakened cap and resulting uncertainty will lead to lengthy and expensive litigation between industry members and SCM/victims' families. Compensation will be delayed. 2. Insurers' costs will rise downstream impact on insurance costs.	1. Hard cap brings certainty, leading to straightforward and prompt settlement of claims up to insured limit. 2. Insurance costs reduced and victims compensated sooner.