



A GUIDE TO AVIATION INSURANCE

International Union of Aerospace Insurers

BACKGROUND

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 230 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.

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.

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

Hull – damage to the aircraft itself.

Passenger – liability for death or injury.

Third party – liability for death and bodily injury (BI) and property damage (PD) external to the aircraft.

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

Hull – insured in a separate war risk insurance market.

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.

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.

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.

11 SEPTEMBER 2001 AND THE IMMEDIATE AFTERMATH

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.

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 description. Following review, war risk cover was then provided for airlines as follows:

Full policy limits for passenger liability arising out of war risks.

Cover limited to a maximum of US\$50m for all third party BI and PD claims during any one 12-month policy period.

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.

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.

SUBSEQUENT DEVELOPMENTS

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.

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.

PRESENT POSITION

The position as at December 2012 can be summarised as follows:

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.

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

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.

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

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.

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.

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.

The most common sub-limit for Third Party war are \$150m or \$250m, although higher or lower sub-limits are also available.

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).

Pricing for this type of cover has continued to fall and for airlines it is now substantially lower than the cost seen in the immediate aftermath of 9/11.

It is important to understand that the aviation insurance market is a very competitive 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.

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