Read the small print

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Was the recent conflict in Lebanon between Hizbollah and Israel terrorism or war?

This is not an academic question for sponsors and financiers of projects in emerging markets. Many projects buy terrorism insurance. But most sponsors and financiers do not buy cover for "war". Standard terrorism insurance policies exclude "war risks": meaning in effect that your coverage for political violence excludes many forms of political violence.

If that seems absurd, it should be remembered that stand-alone terrorism insurance was designed for property in North America and Western Europe, not projects in emerging markets. BPL specialises in emerging market risk and having looked closely at standard terrorism insurance wordings and at the reality of emerging market terrorism, we conclude that standard terrorism insurance falls short of what is required for emerging markets.

The BPL doctrine on emerging market terrorism insurance challenges conventional insurance market thinking by stating that:
1. there is no clear dividing line between "terrorism" on the one hand, and "war" on the other;
2. general property insurance policies never have (and never will) provide the necessary political violence coverage for projects in emerging markets;
3. the stand-alone terrorism insurance market wording (T3/T3a and its variants) does not adequately cover political violence for projects in emerging markets; and
4. effective terrorism and political violence coverage for emerging market projects can only be found in the political risk insurance (PRI) market.

The BPL doctrine is bad news for many projects that have taken a conventional approach to terrorism insurance. However you can switch your terrorism coverage to the PRI market and obtain a better product, designed by insurers who specialise in emerging market risk. The surprise is that the wider cover from the PRI market may well cost less than the standard type of terrorism insurance.

The BPL doctrine is not popular with many in the insurance market. The conventional approach is to argue that terrorism in emerging markets is still terrorism and if it is terrorism, it cannot be war. They maintain that we at BPL Global are wrong to argue that what is happening in Iraq or Lebanon or the Niger Delta or Sri Lanka is not terrorism.

They are missing the point. BPL rejects the idea that terrorism and war are mutually exclusive. We see the two as overlapping: much of what the world calls terrorism is in reality "war risk" in the language of the insurance market. If we are right that terrorism in emerging markets is often both terrorism and war, then we have proved our point: the coverage provided in the "terrorism" cause of loss is trumped by the "war risks" exclusion. As ever in insurance, where an event fits the definition of both an insured peril and an exclusion, the exclusion rules.

It is important that project sponsors and financiers make up their own minds about this issue and take a closer look at both terrorism insurance wordings, and at terrorist organisations in emerging markets.

The key part of the standard terrorism insurance wording is the War Risks Exclusion (see Box 1). A War Risks Exclusion identical or similar to this clause has been a standard feature of all property insurance policies since time immemorial (actually, 1937 to be precise). As can be seen, it excludes not only war, but lesser forms of political violence like civil war, rebellion, revolution and insurrection. We believe that in the context of emerging markets today, this exclusion has real teeth.

After 9/11, the general (re)insurers added a new exclusion of terrorism to all general insurance policies. The stand-alone terrorism market was suddenly reborn. Leading underwriters at Lloyd's developed a policy to "buy back" the new terrorism exclusion. But as the policy had the limited aim of only reproducing the level of cover available under general property policies prior to 9/11 the War Risks Exclusion remained. Thus was born the T3/T3a wording that is the staple of the terrorism insurance market.

The War Risks Exclusion is not hidden in the T3 wording, but appears in the middle of page 1, the second of 14 exclusions under the heading "Losses Excluded". Nor is there much doubt about what the words in it mean. You can look up the legal definition of "rebellion" for example if you want. The activities of many terrorist organisations in emerging markets are better described by that definition of "rebellion" than by T3's definition of "Terrorism". On analysis, the overlap is clear.

The legal arguments, when they come, will no doubt be long and complex. Suffice it to say that when we asked a Queen's Counsel specialising in this field of insurance to review the T3 wording in the context of emerging market terrorism, his conclusion was clear: the T3 wording is a "dog's breakfast".

No great legal knowledge is needed to arrive at the same conclusion: simply read the newspapers or watch CNN or the BBC. Terrorists in Iraq and Afghanistan (and in many other emerging markets) are referred to as "insurgents": but insurrection is an excluded peril from your terrorism cover. Terrorists in the Niger Delta and the Philippines (and in many other emerging markets) are referred to as rebels: but rebellion is an excluded peril in your terrorism insurance.

Conflicts in Sri Lanka and Uganda (and many other emerging markets) are referred to as civil wars: but civil war is an excluded peril in terrorism insurance. And what about guerrilla armies and highly trained militias? Surely they engage in guerrilla warfare, warlike operations and, referring back to conflicts like Lebanon and now Afghanistan, war.

Notwithstanding these fundamental flaws, defenders of T3 argue it has performed so far. Claims have indeed been paid under T3, including in emerging markets. But since 9/11, loss ratios in the stand-alone terrorism insurance market have been low. With a profitable class of insurance, the payment of claims in the current environment says something about the integrity and commercial judgement of the T3 underwriters: it says nothing of the efficacy of the T3 wording. Furthermore terrorism insurance claims in Sri Lanka have been declined by insurers on the basis that the conflict was civil war.

We are not saying that the T3 wording is completely useless: it has its time and place. In the context of the types of terrorist attack likely in London or New York or Madrid the war risks exclusion should not be an issue. No one could seriously argue that on 7/7 there was a rebellion or insurrection occurring in the UK.

Likewise we do not argue that all terrorist incidents in emerging markets would fall foul of the War Risks Exclusion. However as terrorist activity escalates in a country, the activity will become insurrection, rebellion, civil war or even war. Obviously emerging market projects are most at risk to political violence losses if the security situation deteriorates in a country. So as the terrorist violence increases, the more likely it is that the War Risk Exclusion will come into play.

Of course sorting out different types of political violence is immensely complicated. Policies that cover one type while excluding others have long been a source of huge reward for the legal profession. That is why in the area where the London insurance market has hundreds of years of experience of covering war risks – the marine insurance market – terrorism and war risk covers are sold in one seamless product.

By buying a policy that covers one type of political violence and excludes others, T3 buyers are cocking a snook at history. And they are doing so at exactly the wrong time. Most of the world's recent conflicts have not involved opposing nation states. Much of the conflict in the Balkans, in Africa, in Asia and in the Middle East involved or involves informal combatants: fighters who are not part of the official armed forces of a recognised state. The insurgents, rebels, guerrillas and militias may be called "terrorists" but they are still fighting insurrections, rebellions, civil wars and wars, perfectly illustrating the fundamental inconsistency that is embedded in a wording designed for New York or London.

Obviously, the stand-alone terrorism market will carry on selling terrorism policies with a War Risks Exclusion so long as you ask them for standard terrorism cover. But why risk it? Why rely on a terrorism policy with these internal inconsistencies, when you can now buy a terrorism and political violence insurance policy that does not have a broad war and political violence exclusion? The PRI market (rather belatedly) has come to recognise that emerging market terrorism for physical damage and business interruption is part of the political risk spectrum they should cover. Under a PRI market policy, the War Risk Exclusion is removed. Only insurers willing and able to write PRI policies can do this.

Are buyers willing to pay more for the better product? Absolutely not: terrorism insurance is purchased on price, not wording. This is because the sponsors pay the price, and the lenders seldom read the wordings. Happily however broader PRI market cover often costs less.

An infrastructure project in Asia recently moved their terrorism insurance cover to the PRI market. The reason was cost: the renewal quote from the PRI market was $325,000, compared to $500,000 offered by the terrorism insurance market – a 35% saving for the same limit. I am not sure the client really noticed that the words "war, civil war, rebellion, revolution and insurrection" came out of the policy exclusions and were added to the insured perils – quite a bonus as the country in question has a ongoing insurgency involving separatists rebels.

This is not an isolated case. Often the PRI cover is less expensive. Like other PRI market policies, political violence cover is non-cancellable, and can be bought for multi-year periods, again non-cancellable. PRI underwriters are comfortable with emerging market risk and have large portfolios to which political violence covers add diversity. I am therefore not surprised that the PRI market can provide better cover at lower cost for emerging market projects.

The project finance community prides itself on its ability to accurately analyse and mitigate identified risk. Terrorism in emerging markets is an identified risk. But despite its high profile it is not being properly analysed or mitigated.

If you analyse the aims and actions of emerging market terrorist organisations, it will be more than apparent that much of their activity falls into the grip of a full War Risks Exclusion as shown in Box 1.

You now have a choice. You need to check your current terrorism policy and see if it has a War Risks Exclusion. If it does, contact the PRI market.

Alternatively, carry on buying the T3 wording. But if you do, please do not complain if your political violence policy does not respond to many of the forms of political violence that are endemic in emerging markets: the policy will only be living up to its promise, a promise to exclude war risks.

-----Box 1: T3 Terrorism Insurance War Risks Exclusion------

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, civil commotion assuming the proportions of or amounting to an uprising, military or usurped power or martial law or confiscation by order of any Government or public authority