

Options for improving the financial protection against the systemic risks of terrorism and pandemics

Systemic risks such as terrorism and pandemics can cause high financial losses for companies and, in the worst case, insolvencies. At the same time, insuring such risks poses major challenges. First and foremost, the risks are difficult to pool. For terror acts, this is mainly due to the uncertain and low loss probability and for pandemics it is due to the high interdependency of individual risks. Moreover, there are also challenges on the demand side: while demand for terror protection is reduced by an underestimation of loss probabilities, demand for pandemic-related insurance is weakened by an anticipation of public support («charity hazard»).

The report considers how currently existing forms of protection in Germany could be improved, that is, «Extremus Versicherungs-AG» for terror risks and state ex post funding of pandemic losses. For this reason, the report develops, analyses, and evaluates options for improving the protection of German companies against financial consequences of the systemic risks of terrorism and pandemics. A joint coverage in a dual peril insurance policy is not recommendable due to the very different nature of the two risks. This was confirmed in several interviews. Consequently, the report focuses on separate options for terrorism and pandemics.

The analysis shows that minor improvements in the treatment of terror risks are possible within the current Extremus solution. Alternative options have more clear-cut advantages, however, also disadvantages:

- A purely private coverage revokes the state guarantee and slightly increases efficiency. However, the already very low extent of insurance density declines further.
- Transforming Extremus into a special reinsurer with a state guarantee increases the extent as well as the efficiency of protection. However, this requires a higher public guarantee.
- A purely public ex post funding has the advantage of full coverage but significantly increases the risk for the federal budget.

Economic losses in a pandemic have different causes that differ in their insurability. For this reason, the report suggests to separately consider the following «sub-risks»:

- Declines in sales may not be attributed to a specific measure and are highly dependent on entrepreneurial decisions. Therefore, declines in sales are not insurable, and moreover, unsuitable as a proof of loss or a basis for assessment.
- Individual business interruptions, for instance due to ill employees, can be pooled. Consequently, an insurance solution is efficient. However, it is questionable whether the private insurance market would lead to the politically desired extent of coverage. Particularly in the phase of capacity generation, the participation of a special reinsurer with a state guarantee could yield a higher extent of coverage but also a higher financial risk for the federal government.
- General shutdowns cannot be pooled, and thus, are not insurable. Since the losses are linked to government decisions, its participation in a solution is incentive compatible. Purely state ex post funding entails uncertainty about future capital procurement and require a high degree of budgetary discipline. However, in contrast to approaches with ex ante financing (whether through an insurance or a capital pool), ex post funding avoids the opportunity cost of tied-up capital.

The different options for treating terror and pandemic risks have different advantages but there is not a single option which is superior in all criteria. A reason for this is that some of the criteria are conflicting (e.g., high degree of protection and low risk for public finance). Hence, the recommended cause of action depends on the weights given to the different criteria. This is, however, a political question and not part of the report.