

Yaw Otu Mankata Nyampong

Insuring the Air Transport Industry Against Aviation War and Terrorism Risks and Allied Perils

Issues and Options in a
Post-September 11, 2001 Environment



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Foreword

I am pleased to welcome the publication of this work by Dr. Nyampong, a colleague at the Institute of Air and Space Law at McGill University in Montreal.

This work provides a careful and detailed analysis of the insurance implications of the tragic events of September 11, 2001, involving the terrorist attack on the World Trade Center in New York. It includes discussion of the history, structure and workings of the international insurance market which provides cover against the risks of aviation war and terrorism, the impact of the events of September 11, 2001 on the aviation war and terrorism insurance market, and the response on the part of the insurers of said risks to September 11, including the forms and limits of coverage currently available in the market in respect of such risks.

September 11, 2001 brought to light certain fundamental problems inherent in the insurance of aviation war and terrorism risks. In the 11 years that have since elapsed, many initiatives have been proposed (some even implemented) at the national, regional and international levels to address these problems. Unfortunately, however, a permanent and sustainable solution to the problem has not been found as yet, and it is feared that the commercial aviation insurance market (which continues to provide primary insurance coverage for such risks) may not have the requisite capacity to bear the financial consequences of another large terrorist attack that involves the air transport system.

This work makes a significant contribution to the search for a permanent and sustainable solution to the problem by carefully analyzing and exploring the root causes thereof from a multidisciplinary perspective. In so doing, the book traces the rationale underlying the historical exclusion of war and terrorism risks from property/casualty and marine insurance contracts, and examines the manner in which these exclusionary practices were subsequently extended to, and have since evolved in, the aviation insurance market. Aside from insurance, this work also analyzes other different traditional and innovative mechanisms of risk transfer and risk management to determine whether they are perhaps better suited to provide permanent and sustainable coverage for aviation war and terrorism risks. The work concludes by identifying and proffering a number of recommendations on how to achieve permanent and sustainable coverage of aviation war and terrorism risks.

I commend this book to all who have a practical, legal or academic interest in aviation insurance, including particularly those with an interest or involvement in the insurance aspects of aviation war and terrorism risks.

Los Angeles
September 2012

Rod Margo

Preface

The saying that the terrorist events of September 11, 2001, changed the world forever is true not only in respect of how it changed the conduct of international relations between states but also in respect of the manner in which it affected the provision of insurance coverage for aviation war and terrorism risks. Although the quantum of loss and compensation that insurers had to pay as a result of the events of September 11, 2001, was unprecedented, events of such nature were not entirely new to the insurance market particularly the London aviation market where coverage of aviation war and terrorism risks was commonly provided. Indeed, the 1968 Israeli attack on Beirut airport is on record as the first major event of that nature that targeted the international air transport system. This marked the beginning of the exclusion of war and allied risks from aviation insurance policies issued in the London market, a practice that was successively expanded and developed as many more such events occurred over time. A few days after the fateful events of September 11, 2001, however, it became abundantly clear to everyone who had something to do with the air transport industry that the business-as-usual era in which airlines could obtain from commercial insurers as much insurance coverage for aviation war and terrorism risks as they desired was over and that the time had come to begin the difficult process of finding other reliable risk transfer mechanisms to serve as alternatives and/or complements to traditional insurance.

A review of the literature at the time indicated that the question of how to provide or ensure the provision of sustainable insurance (or other financial) coverage for aviation war and terrorism risks had not been addressed in a comprehensive manner by academicians, insurance practitioners, and government policymakers. What really complicated the issue is the fact that, in most countries, the law requires an air transport operator to maintain adequate insurance coverage (including coverage for war and terrorism risks) as a condition for the initial grant and continuing validity of an air operator's certificate. There being no mechanism to ensure that what the law requires as minimum insurance requirements would be available commercially or otherwise to airlines, events such as those of September 11, 2001, almost brought the global air transport industry to a halt. Proposals of all kind and manner were advanced, driven by the urgent desire to find a solution to the

problem and the tendency to transpose solutions that have been successfully implemented in other areas of economic endeavor. Unfortunately, very little effort was directed toward determining what the root cause(s) of the problem were. As a result, most of the solutions that were implemented have either failed or remained stillborn.

In light of the foregoing, the rationale underlying my research and ultimately this book was to take a step back and look critically at the problem of how to provide sustainable insurance coverage for aviation war and terrorism risks, not only from a legal perspective but also taking into account various other nonlegal phenomena that could help delineate the exact boundaries of the problem before prescribing any solutions. In order to do so, it was important as a first step to provide readers with an overview of aviation insurance as practiced in the London market (and, subject to some marked differences in a few places, throughout the wider Common Law world). This is followed by a specific focus on how the commercial insurance market has addressed marine and subsequently aviation war and terrorism risks over the years. The book then analyzes the behavior of the commercial insurance markets to extreme events such as September 11, 2001, by resorting to a number of concepts and models propounded by eminent scholars in the fields of law and economics as well as behavioral law and economics. One of the major findings is that as a means of risk management, insurance works best under circumstances where the law of large numbers applies—large population size characterized by high frequency of occurrence of the risk concerned but a significantly low financial impact on each occurrence. Aviation war and terrorism risks on the other hand belong to the class of risks that are typically low frequency/high financial impact. As such, insurer appetite for those types of risks decreases as the size of the latest occurrence (payout) increases.

Clearly, if the commercial insurance markets alone cannot be expected to insure these risks at societally desirable levels and in a sustainable fashion, then it is imperative that alternatives and complementary solutions be found. The book therefore considers the extent to which capital markets, governments, and the international community of states (three of the many proposed solutions) may provide alternative or complementary mechanisms to the coverage of aviation war and terrorism risks by commercial insurers. Each of these raises peculiar issues which are discussed from a multidisciplinary perspective. Thus government-run insurance and guarantee schemes for air transport operators in a number of countries are analyzed along with the numerous issues associated therewith. For instance, it has been alleged that a domestic war and terrorism insurance market for air transport operations has not been able to develop due mainly to the federal government's continued provision of premium war risk insurance coverage to US airlines. At the international level, most states consider that aviation war and terrorism risks are a direct manifestation of each state's foreign policy. As such it has been difficult to develop an international mechanism that will address the insurance and financial aspects of such risks to the satisfaction of all (or at least a majority of) states. Capital market solutions on the other hand offer unique opportunities and deeper capital reserves for the insurance of such risks. However,

it is important to tread with caution and to learn lessons from the recent economic crisis.

It is my hope that this exposition will enable policymakers, decision makers, government regulators, air transport operators, airlines, and their insurers to have a broader view of what aviation war and terrorism risk insurance really entails. It is intended to encourage and facilitate discussion and reflection about the way forward.

Montreal, QC, Canada

Yaw Otu Mankata Nyampong

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The manuscript that forms the basis of this book was written in partial fulfillment of the requirements of the Doctor of Civil Law degree program at the Institute of Air and Space Law, Faculty of Law, McGill University. I wish to express my deepest and most profound gratitude to Professor Paul Stephen Dempsey, Tomlinson Professor of Global Governance in Air and Space Law and Director of the Institute of Air and Space Law at McGill University for devoting his time, energy, and attention to the supervision of my dissertation and for providing me with invaluable guidance, encouragement, and support throughout my long years of research and writing at the Institute. I am also extremely grateful to him for employing me as the editor of the *Annals of Air and Space Law* since April 2007. This paid part-time position enabled me to provide for my family while studying full-time at McGill.

I also wish to express sincere gratitude to Professors Stephen Smith and H. Patrick Glenn, members of my advisory thesis committee. Their recommendations and suggestions during the earlier stages of my research provided me with broader insights and perspectives on the subject—perspectives which have heavily influenced the final shape of this book. I wish to thank Professor Ram Jakhu, Maria D’Amico, Mark Glynn, Ari Munisami, Kuan Wei (David) Chen, and indeed all my other colleagues at the Institute of Air and Space Law for their numerous (and at times unwelcome) distractions. These helped me maintain my sanity and prodded me on to finish this project.

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Finally, I wish to express my heartfelt appreciation and gratitude to my dear wife Emma Agyei-Dwarko for her support, patience, and understanding throughout my long years of graduate studies and to my children Yvonne, Yvette, and Fredo for their forbearance. I am also extremely grateful to my mother-in-law, Comfort Safoa Agyei, for enduring bitterly cold winters in Montreal for three consecutive years at my request and for providing indispensable babysitting services during that period.

I remain solely responsible for the views expressed in this book as well as any errors and omissions in the text.

This book is entirely dedicated to Emma, Yvonne, Yvette, and Fredo.

Yaw Otu Mankata Nyampong

List of Acronyms

9/11	September 11, 2001
ABS-CDOs	Asset-Backed Securities Collateralized Debt Obligations
AEA	Association of European Airlines
AICG	Aviation Insurance Clauses Group
AIGFP	AIG Financial Products
ARF	Alternative Risk Financing
ARM	Adjustable Rate Mortgages
ART	Alternative Risk Transfer
ATA	Air Transport Association of America
AVN 48	War, Hi-jacking and Other Perils Exclusion Clause (Aviation)
AVN 51	Extended Coverage Endorsement (Aircraft Hulls)
AVN 52	Extended Coverage Endorsement (Aviation Liabilities)
Cat-Bonds	Catastrophe bonds
CatEPut	Catastrophe Equity Put option
CDOs	Collateralized Debt Obligations
CDS	Credit Default Swap
CSFB	Credit Suisse First Boston
CWEC	Common North American Airline War Exclusion clause
EOL	Excess of Loss
EU	European Union
EUMS	EU Member States
FAA	Federal Aviation Administration of the US DOT
Fannie Mae	Federal National Mortgage Association (US)
FC & S	Free from Capture and Seizure clause
FIFA	Fédération Internationale de Football Association
FOR	Fire Offices Committee
Freddie Mac	Federal Home Loan Mortgage Corporation (US)
GRC	General Risks Convention
IAIS	International Association of Insurance Supervisors
ICAO	International Civil Aviation Organization
IOPC Fund	International Oil Pollution Compensation Fund

JTCC	Joint Technical and Clauses Committee
LSW 555	Aviation Hull (War and Allied Perils) Insurance Policy – London Special Wording
MTOM	Maximum certificated Take-Off Mass of aircraft
OECD	Organization for Economic Cooperation and Development
PFLP	Popular Front for the Liberation of Palestine
RCDI	Reverse Convertible Debt Instrument
RRG	Risk Retention Group
SG Policy	Lloyds Ship and Goods policy
SGMR	Special Group on the Modernization of the Rome Convention of 1952
SGWI	Special Group on War Risk Insurance
SPRV	Special Purpose Reinsurance Vehicle
SPV	Special Purpose Vehicle
UIC	Unlawful Interference Compensation Convention
US DOT	Department of Transportation of the Government of United States of America
WMD	Weapons of Mass Destruction
WTC	World Trade Center

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