HM Treasury

HM Treasury Review of Pool Reinsurance Company Limited:

Call for Evidence - Response

March 2022

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Chapter 1
Introduction

1.1 HM Treasury (HMT) is committed to reviewing its relationship with Pool Re (the government backed terrorism reinsurer) regularly to ensure that it continues to operate in the best interests of Pool Re and its members, the government, the taxpayer and the wider economy. The most recent review was announced on 3 September 2020[1].

1.2 On 12 October 2020 the government published a Call for Evidence[2] to inform the review. The Call for Evidence closed for responses on 22 November 2020. It covered how the guarantee extended by HMT to Pool Re impacts the market for terrorism reinsurance and how any amendments to the terms of the guarantee and the rules that govern HMT's relationship with Pool Re would impact the availability, affordability and take-up of terrorism insurance.

Summary of responses

1.3 The Call for Evidence encouraged respondents to respond to a set of questions with views and evidence on four main areas set out in the document:

- HMT's guarantee of Pool Re;
- increasing reliance on the private market;
- the scheme rules and structure of Pool Re;
- small business access to terrorism insurance.

1.4 The government would like to thank all the respondents to the Call for Evidence. In total, 53 written responses were received[3]. Respondents can be broken down into the following:

- 22 insurance firms, specifically: four combined life and general insurers, six specialist insurers, eight general insurers and four reinsurance firms. 18 of these are members of Pool Re.
- Eight industry representative bodies;
- Three consultancies, law firms, etc;
- Eight members of the public;

1 See https://www.gov.uk/government/news/hmt-launches-review-of-pool-reinsurance-limited

2 See https://www.gov.uk/government/consultations/hm-treasury-review-of-pool-reinsurance-ltd-2020-2021-call-for-evidence

3 During the Call for Evidence period, HMT held bilateral meetings with stakeholders with an interest in the Review.

- 12 other organisations.

1.5 This response document covers the four themes covered by the Call for Evidence. Not all respondents answered every question and some submitted general information or an overall summary. Some responses covered aspects of the scheme or wider topics which sit outside of the scope of the review; where this is the case, this information has not been included.

Chapter 2
HM Treasury's guarantee of Pool Re

Removal of guarantee

2.1 Respondents were overwhelmingly supportive of the continuation of the Pool Re scheme and that Pool Re had been a positive force in Great Britain's reinsurance markets since its establishment. No respondents argued that Pool Re should be wound down or replaced by a different scheme.

2.2 Respondents argued that limiting or removing the HMT guarantee would prompt significant market disruption. They did not expect the reinsurance market to step in and replace the scheme's capacity, and noted that the chemical, biological, radioactive and nuclear (CBRN) cover in particular was not available commercially. They expected a reduction in cover available would then also lead to prices overall rising significantly.

2.3 Respondents gave a range of views on whether the market could deliver sufficient affordable terrorism insurance if HMT withdrew the guarantee for conventional cover but left it in place for non-conventional (CBRN and cyber-triggered terrorism) risk. Whilst most respondents thought that the market could not provide the full cover, some suggested an acceptable level could be maintained. However, more data would need to be made available as firms do not hold as much historical data in comparison when modelling this risk.

Capping of guarantee

2.4 Responses on the implications of capping the guarantee varied. Most respondents were concerned about the effect of a cap on insurers' ability to meet claims, and how this would work in practice e.g., if the total cost of an attack stood at £60 billion with a guarantee capped at £30 billion, how would pay-outs be calculated and apportioned and the practicalities which would vary for an annual or per event cap. They were concerned that this added complexity to the scheme would leave consumers uncertain on the extent of their coverage.

2.5 However, some respondents supported capping the guarantee at either £30 billion or £100 billion. They pointed to successful international comparisons which have caps and argued that this could level the playing field with other reinsurance firms, foster greater market participation and move risk back to the market.

2.6 Other respondents predicted that a cap would not reduce availability and affordability of cover if insurers also capped their own exposures in turn, with the cost passing to consumers as they would receive a lower pay-out on their claim. They noted this transition would need to be handled very carefully with full transparency to manage the expectations of policyholders and avoid reputational risks and damage in consumer confidence in the event of the value of the claims exceeded the cap.

Other implications

2.7 Respondents felt that the ultimate cost of a reduction in or removal of HMT's guarantee would be a decline in investment in buildings and infrastructure in high-risk areas which would dampen economic growth.

2.8 There was an expectation that Pool Re could lose its Solvency-II exemption if the guarantee was removed or capped in any way. They assumed this would require Pool Re and its members to hold additional capital against these risks in line with the regulatory requirements and these added costs could then be passed on to policyholders, impacting SMEs in particular. There was also concern that certain members would withdraw completely. Through our further engagement with the Prudential Regulatory Authority however, it was found that there was potential scope for the exemption to remain as long as the guarantee fully covered Pool Re's obligations (therefore liabilities would have to be capped in turn accordingly).

2.9 A few respondents offered further proposals on how to return risk back to the market, which included raising excess levels to a point where members only resorted to Pool Re for the most extreme of loss-events; creating a new mutual to raise Pool Re's attachment point; increasing the member excess levels without affecting capacity or capping the guarantee.

Chapter Questions

1. What would be the impact on the availability and affordability of terrorism insurance of increasing members' retentions? In your response it would be helpful if you could be as specific as possible.

2. What factors need to be assessed in deciding whether the HMT guarantee of Pool Re remains necessary to ensure the ongoing availability and affordability of terrorism (re)insurance cover to all market participants who seek it?

3. Would the HMT guarantee of Pool Re remain necessary to ensure the ongoing availability and affordability of terrorism (re)insurance cover for purely conventional terrorism risk if a guarantee remained in place for CBRN and cyber triggered terrorism risks? In your answer please be specific about what (if any) form of terrorism risk the market could handle without government intervention and detail any barriers you foresee to splitting the market in such a way.

4. If the HMT guarantee of Pool Re was capped, what would be the expected impact on the availability or affordability of terrorism insurance cover? Do you expect that (re)insurers may have to adapt their products to reflect this? For illustrative purposes, we ask that respondents consider the impact of a cap at two different levels £30 billion and £100 billion, and the possibility of a cap being per event or an annual limit.

5. If a cap on the HMT guarantee was introduced and depending on the nature of the cap, it could result in Pool Re being required to meet a Solvency II 11 capital requirement. How would this impact on the availability and affordability of terrorism insurance?

6. Would you like to flag or propose a change to the HMT's guarantee of Pool Re? How would your proposal be effective in transferring some or all of the risk currently held by Pool Re back to the market?

Chapter 3

Increasing reliance on the private market

Excess levels

3.1 Respondents were asked to give views on increasing the level of risk Pool Re's insurer members retain. This means the level of claims that members pay ahead of recourse to their reinsurance through the scheme.

3.2 Most respondents supported increasing their level of excess, also known as retentions, as an efficient way to return risk to the market and to have members "actively manage" their risk; predicting that it would make the market more dynamic and competitive, and in turn create a more appropriate and competitive pricing of risk.

3.3 Some respondents highlighted that while there has already been an increase in excess levels, if Pool Re were to increase this further, this should be done incrementally cognisant that members' appetite is limited. Some warned that if there was insufficient 'infill' reinsurance capacity from the market to protect members' own excess[4], some (especially smaller) members may struggle and/or withdraw completely. Others warned that higher excess levels could leave terrorism cover more susceptible to insurance underwriting cycles and post-loss withdrawals from the market, which would result in a reduction in availability and sharp increases in the price of terrorism cover at times of increased risk.

3.4 A few respondents said that access to high quality risk modelling was a prerequisite to any increase in the excess levels. This was supported by one response which claimed that most members have insufficient skills to model their risk, without which they would find themselves with surplus or insufficient levels of capital, creating inefficiencies and added costs.

3.5 Respondents highlighted the inability to differentiate risk (bifurcation of conventional and non-conventional terrorism risk) as a restricting factor in transferring risk back to the market see chapter 4).

Reinsurance and Insurance Linked Securities

3.6 Views were also sought on whether there is scope for Pool Re to increase its purchasing of reinsurance and issue further Insurance Linked Securities (ILS)[5].

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[4] Members would reinsure their exposure from increased levels of excess if raised beyond their risk appetite.

[5] ILS are financial instruments whose values are driven by insurance loss events, the return from which is uncorrelated with that of the general financial market. They allow insurance and reinsurance carriers to transfer

3.7 All respondents viewed Pool Re's reinsurance programme as a valuable mechanism for returning the risk back to the market; the largest in the world that was successfully tapping into international markets, and which should be expanded if possible. Many respondents argued that Pool Re was placing the maximum possible reinsurance, using all reasonably priced capacity in the market.

3.8 Responses were a little more varied on ILS; some thought it may be possible to increase the placement at the next issuance given the current low-interest rate and benign terrorism risk environment. Others reiterated this capacity may dry up following a loss-event.

Other suggestions

3.9 Other alternatives that were suggested included:

- Focusing on greater uptake and penetration to diversify the portfolio, thus increasing appetite and excess levels.
- The government indemnifying all unknown causes of terrorism as they constantly evolve if the market agrees to cover the specific known causes.
- Developing reciprocal reinsurances with other global terrorism pools to diversify risk internationally and source extra capacity.

Chapter Questions

7. What would be the impact on the availability and affordability of terrorism insurance of increasing members' retentions? In your response it would be helpful if you could be as specific as possible.
8. What are the factors affecting members ability to retain more terrorism risk? How could government and/or Pool Re enable further retention of this risk by private insurers?
9. Do you think that there is a market for additional insurance linked securities (ILS) in excess of what has already been issued? What do you expect would be the impact on the market appetite for such products following a major terrorist event?
10. Do you think there is a market for further retrocession in addition to that which has already been bought by Pool Re? What do you expect would be the impact on the market appetite for such products following a major terrorist event?
11. Please set out any proposals by which further risk could be returned to the market that are not currently part of Pool Re's working practices.
12. Please set out any ways by which Pool Re may inadvertently be prohibiting the emergence of a larger private market for terrorism reinsurance. We would welcome comments on pricing practices compared to other market reinsurers.

risk to the capital markets and raise capital or capacity. Some insurance-linked securities (mainly catastrophe bonds) can be traded among investors and on the secondary-market.

Chapter 4

Scheme rules and structure of Pool Re

4.1 Pool Re's reinsurance prices are currently based on four basic geographical risk zones which drive consumer pricing. In addition, any terrorism risk written by Pool Re's members is reinsured through the scheme under a single excess for any type of terrorism claim.

Treaty

4.2 Many respondents felt that the Pool Re scheme could be improved by changing the current structure of reinsurance to a treaty model. Most respondents were widely supportive of this move, while some caveated that the effectiveness of such a move would be reliant on greater modelling capacity to ensure members understood their risk exposures. Respondents highlighted that a move to treaty would make it easier for members to offer terrorism insurance and this approach would continue to be effective at preventing adverse selection by the members.

4.3 On the other hand, a few respondents welcomed the simplicity and transparency of Pool Re's current "clean" channelling of exposures which came with the current facultative-obligatory system. Others warned that any change to the structure and accompanying rules would need to be clear on the practicalities and the approach specifically on risks e.g., where these could overlap and how they aggregate.

Bifurcation of risk

4.4 Moving to a treaty model would allow for the bifurcation of conventional and non-conventional risk which in turn would enable members to increase their excess for conventional risk thereby transferring more of this back to the market. Many respondents supported this proposal, emphasising that greater excess levels would also provide greater retained premiums acting as an incentive for members. One respondent pointed out that infill retrocession would be easier to obtain for conventional risks with bifurcation, by removing CBRN and Cyber triggered terrorism from the risk.

4.5 Some respondents suggested that Pool Re could bifurcate the risks in order to withdraw all cover for events with more conventional risk profiles, leaving it instead to the private market. However, they cautioned that doing so would increase Pool Re's pricing, destabilise its income, create market instability and potentially cause other unintended consequences. Ultimately, not all members would have the appetite to retain this extra risk. One respondent suggested different membership statuses, which would allow members to either cede or retain different types of risks according to their appetite. This would provide a transfer of risk back to the market which accounted for individual members' circumstances.

4.6 Respondents suggested other various ways of differentiating the risk:

- By occupancy and geography.
- With greater modelling and analysis, non-conventional terrorism risk could be broken down further into Chemical/Biological and Radiological/Nuclear.
- Segmentation by property damage, business interruption, non-damage business interruption, Cyberattack on infrastructure, non-damage Cyber specific to a building.

Scheme Rules

4.7 Two anti-selection scheme rules have been in place since Pool Re's inception. The 'Cede all business' and 'All or Nothing' rule which stop policyholders and members from ceding only the riskiest policies to Pool Re. Such adverse selection would reduce the diversity of the risks underwritten by Pool Re and eliminate the benefits of pooling risk.

4.8 Respondents suggested that while it was theoretically possible that the scheme rules might be discouraging the emergence of a private market, the scheme rules were market norms and there would be adverse impacts if Pool Re did not adopt them. For example, Pool Re would face adverse selection and it would struggle to purchase its own commercial reinsurance with a riskier portfolio. This would thereby increase the taxpayers' exposure. One respondent suggested that Pool Re would need the ability to charge levies to counter the costs of adverse selection if the rules were removed.

4.9 However, these risks would have to be weighed against the benefits e.g., potential for increased excess levels and greater market participation and penetration, from amending the rules.

4.10 One respondent suggested that the rules were unnecessary on the basis that insurers already have their own anti-selection practices. They argued that the rules were too restrictive with greater flexibility needed by members. They were also impractical as compliance could not be assured with many of the policies purchased online.

4.11 Many respondents warned that changes to the scheme's structure and bifurcation of the risk could result in the adverse selection that the scheme rules sought to circumvent.

Chapter Questions

13. Would a revised structure for Pool Re which enables members to differentiate the treatment of different types of risk they reinsure with Pool Re allow for higher member retentions on some types of risk?
14. If such a system were to be introduced, how could terrorism insurance risks best be segmented? Please specify where (and to what extent) insurers could retain additional risk under such a model.
15. Could the 'Cede all Business' requirement be amended to continue to avoid significant adverse selection yet be compatible with the risk differentiation set out in Q12?
16. What would you expect the impact on the availability and affordability of terrorism (re)insurance to be of significantly amending the 'Cede all Business' requirement to allow differentiation between risk types? Would this impact the balance of policies being written by Pool Re and other market reinsurers?
17. Could the 'All or Nothing' rule be amended to continue to avoid significant adverse selection yet facilitate the return of further risk to the market and be compatible with the risk differentiation set out in Q12?
18. Would it be beneficial for members and/or the wider terrorism (re)insurance market to allow policy holders to select in such a way?
19. What changes could the UK's regulatory authorities make to enable an environment more conducive to increasing private market participation in terrorism risk, and promote economic resilience to terrorism risk?

Chapter 5

Small and medium-sized enterprises (SME) access to terrorism insurance

5.1 It is the responsibility of individual businesses to buy appropriate insurance cover that meets their specific needs and increases their economic resilience against future terrorism threats. The insurance sector estimates that only a very small proportion of small and medium size enterprises (SMEs) have this cover. As part of the Call for Evidence, HMT was keen to understand better the reasons behind this and how uptake can be increased.

5.2 Respondents frequently quoted a figure of 10-20% on SME uptake for this cover. Some noted that uptake was lower in non-metropolitan areas and, as expected, on the more micro end of the SME scale.

Awareness

5.3 Respondents felt that a lack of awareness of terrorism risk among SMEs was acting as a significant barrier to greater uptake. Many recommended targeted guidance and/or awareness campaigns to address this. Such a campaign could target the fact that SMEs do not see value in taking out cover as they did not understand the full extent of their potential exposure.

5.4 Some respondents pointed to the role of the regulators in encouraging a greater understanding of terrorism risk and the availability of insurance products. Others argued that terrorism cover should be offered as a separate product - SMEs did not see it as necessary and were more familiar purchasing standard comprehensive products.

Affordability

5.5 Another major factor highlighted around accessing terrorism cover was price. A few respondents suggested more affordable policies would drive uptake. To achieve this some suggested that Pool Re should reduce its rates, insurers should look at potential discount solutions, and more risk-reflective pricing be implemented via the differentiation of terrorism risk.

5.6 Responses were divided on whether the proposal to move to treaty and bifurcate risks would deliver higher uptake from businesses. While some predicted that lower costs could be passed on to policyholders therefore improving uptake, others were concerned at increasing the complexity of the scheme, which could be detrimental to uptake.

Alternative suggestions

5.7 Other suggestions to increase uptake included:

- Requirements introduced by lenders, for example making terrorism cover a requirement for a loan.
- Automatic inclusion of terrorism cover in standard commercial property cover with an opt-out clause.
- Making terrorism cover mandatory for SMEs.
- Regulatory authorities could review tax arrangements, for example allowing tax breaks for SMEs and better management of risks.

Chapter Questions

20. What percentage of SMEs do you estimate to have cover for a terrorist attack?
21. What are the incentives or disincentives insurers and brokers face in the sale of terrorism cover to SMEs? Please draw comparisons to other insurance products, for example conventional commercial property insurance.
22. What do you think drives the uptake of terrorism insurance by SMEs, and what measures could be taken by the insurance industry to encourage this further?
23. What changes could the UK's regulatory authorities make to enable an environment more conducive to the uptake of terrorism cover by SMEs? Please include if you think it would be positive for insurers to be able to offer the cover in different ways (such as included in standard commercial property cover).
24. What changes could Pool Re make to its model to make it easier for insurers to offer terrorism insurance? Would a system that allows for more risk reflective pricing including differentiation between different types of terrorism risk support this?

Chapter 6

Next Steps

6.1 The responses received by HMT in this Call for Evidence have been fed into the wider review of Pool Re, which has now concluded. We thank all those who participated and provided their views on the scheme. The findings and outcomes of the review are available here . These findings reflect the responses received in the Call for Evidence along with the assessment and detailed consideration undertaken by HMT with support from the Government Actuary's Department (GAD).

Annex A

List of consultation respondents

Association of British Insurers (ABI)

Ageas

AIG

Allianz

Allianz Global Corporate & Specialty SE

Allied World

Aon

Arl Partners

Aspen

Aviva

AXA

British Insurance Brokers' Association (BIBA)

Blue Bay Asset Management

British Property Federation

British Vehicle Rental and Leasing Association

Canary Wharf Group

Confederation of British Industry (CBI)

Chief Scientific Adviser National Security

CNA Hardy

Cranfield University

Direct Line Group (DLG)

Ecclesiastical

Federation of Small Businesses

Fermat Capital Management, LLC

FM Global

GAREAT

Guy Carpenter & Marsh

Hanover Life Bermuda

Institute and Faculty of Actuaries

Landsec

London & International Insurance Brokers Association (LIIBA)

Lloyd's of London

Lord Browne of Ladyton, Lord Arbuthnot, Lord Stevenson of Balmacara, Lord Harries of Haringey, Lord O'Donnell and Lord Clement Jones

Mark Field MP

Michael Wade

Michael Clarke

NFU Mutual

Ontario Teachers' Pension Plan Board

PIMCO Investment Managers

Professor Sir David Omand

QBE

Robbie Lyle (CDMA)

RSA

Rupert Atkin

Royal United Services Institute (RUSI)

Shroders

Sir John Scarlett and Lord Carlile of Berriew

Stephen Catlin - Convex

Swiss Re

The Business School (formerly Cass)

Travelers Insurance Company Limited

WRB Underwriting Lloyd’s Syndicate 1967

Zurich