HM Treasury

HM Treasury's review of Pool Reinsurance Company Limited: Final Report

March 2022

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Foreword

Pool Re was an organisation born out of tragedy - founded in the aftermath of a series of bomb attacks in the early 90s. However, in the three decades that followed its launch Pool Re has given millions of British businesses certainty by enabling them to insure against terrorism.

Much of Pool Re's success stems from the fact that it has never stopped evolving. Over the years the scheme's scope has expanded to reflect the changing nature of terrorism. Today its cover includes chemical, biological, radiological, and nuclear risks, along with non-damage business interruption and the physical and direct business interruption impacts of cyber terrorism.

Pool Re has also rightly gained a reputation for excellence. It has pioneered the return of terror cover to insurance markets. It has the world's largest terrorism reinsurance programme. While Pool Re is still underpinned by the government, its financial strength means that any loss would have to exceed over £11 billion before the taxpayer would need to step in. In addition, as the organisation that placed the world's first ever terrorism catastrophe bond, Pool Re remains at the forefront of insurance innovation.

Undoubtedly these achievements have led to the emergence of early stages of growth in the purely private terrorism reinsurance market. These new market entrants mean that not all businesses that buy terrorism cover now rely on Pool Re. However, terrorism is an unpredictable risk. As a result, Pool Re continues to be of critical importance for the bulk of the UK terrorism insurance market.

This means that it is vital that Pool Re continues functioning as effectively as possible and keeps pace with market change. That's why in September 2020, the Treasury launched this review of Pool Re and its strategic partnership with the Treasury, in line with the commitment to regular reviews we made in 2014.

This document sets out the review's findings and the strategic direction for the scheme that the government has agreed with Pool Re over the next five years. Ultimately, these steps should ensure that Pool Re works well in the modern world and continues to innovate in response to the evolving needs of customers, the market and government.

As a result of these changes, businesses will continue be able to obtain the terrorism cover they need easily and efficiently. Premiums will better reflect risk and cover should become more affordable. Importantly, these changes will mean the taxpayer will never be on the hook for costs that could be covered by the private market.

I am pleased that the measures are supported by Pool Re and its members. And I have every confidence that these changes will strengthen the UK terrorism insurance sector so it can continue to provide its customers with the security they so rightly deserve.

John Glen, Economic Secretary to the Treasury

Chapter 1

Overview of review findings

Mitigating the risk to the taxpayer of the unlimited guarantee

1.1 The current unlimited HMT guarantee of Pool Re remains important to the provision of terrorism insurance in Great Britain. It also poses a significant fiscal risk to the government, making it essential that taxpayer interests are protected. HMT will continue to provide an unlimited guarantee subject to:

- Pool Re proactively returning risk to the market.
- Pool Re not paying special dividends or otherwise reducing its reserves without HMT permission.
- HMT ensuring funds on the public accounts are used appropriately by taking a power of statutory direction over bodies benefiting from a guarantee under the relevant legislation (subject to Parliamentary approval).

Modernising Pool Re's system of reinsurance

1.2 Subject to the development of an appropriate proposal including the change being manageable for all firms, Pool Re has permission to move to a treaty system of reinsurance, under which the current underwriting manual would be removed and instead Pool Re would provide its members with portfolio pricing and access to a model based on more detailed and accurate geospatial data.

Transferring risk back to the market

1.3 HMT has asked Pool Re to develop a detailed proposal on the bifurcation of member excess to enable its members to retain more conventional terrorism risk without increasing their exposure to non-conventional terrorism (chemical, biological, radiological and nuclear (CBRN) or cyber terrorism) risk. HMT approval will be contingent on any reduction in taxpayer remuneration reflecting a proportionate reduction in risk.

Promoting competition in the market

1.4 The review found that the anti-selection scheme rules, in place to avoid the private market cherry-picking the best polices and ceding the least favourable risks to the scheme, are not inhibiting the development of a private market and remain important to protecting the interests of the scheme and by extension taxpayers.

Increasing SME uptake of terrorism insurance

1.5 With the support of HMT, to reflect the contemporary modelling techniques it can now deploy, Pool Re has agreed to reduce overall scheme pricing by 20% to make cover more affordable. HMG and Pool Re will collaborate to address a lack of awareness amongst Small Medium Enterprises (SMEs) about the availability and benefits of cover, utilising and building on the Information Sharing Platform Project.

Meeting the expectations of Parliament

1.6 Subject to Parliamentary approval, HMT proposes to amend the Reinsurance (Acts of Terrorism) Act 1993. This would give HMT Ministers the power to direct any public sector body extended a guarantee, or benefiting from an arrangement, under the Act to comply with relevant HMG controls aimed at ensuring they meet the expectations of Parliament.

Chapter 2
Background

2.1 Pool Reinsurance Company Limited (Pool Re) is a mutual company that was established in 1993 when a series of terrorist attacks in Great Britain prompted reinsurers to withdraw from the terrorism insurance market. The government's unlimited guarantee of the scheme (a commitment to extend a repayable loan if needed) meant that insurers were able to access adequate and affordable reinsurance cover for terrorism losses. Details on the origins and structure of the scheme are set out in Annex A.

2.2 HMT is committed to reviewing its relationship with Pool Re every five years to ensure that its relationship and the scheme continue to operate in the best interests of Pool Re and its members, the government, the taxpayer and the wider economy. This review was launched in September 2020 and is designed to formalise the strategic direction of Pool Re for the coming 5 years.

2.3 The headline Terms of Reference for this review were:

- Assessing if the risk share between HMG and the private sector remains appropriate for the good functioning of the UK's terrorism reinsurance market.
- Considering if the scheme rules that govern Pool Re require updating to enable or formalise operating practices which are of mutual interest.
- Ensuring that the requirements HMG sets for bodies classified by the ONS to the central government sub-sector are met, without compromising Pool Re's ability to operate effectively.

2.4 In reaching its conclusions, HMT assessed data and qualitative analysis provided by Pool Re alongside an independent review from the Government Actuary's Department (GAD). A public Call for Evidence also ran between 12 October 2020 and on 22 November 2020 to inform the review, which received 53 responses. A summary of the responses received is available here. HMT also met with international counterparts from Australia, the USA, the Netherlands, Denmark and Belgium to understand the different terrorism reinsurance models. The findings reflect this work and HMT's assessment of the proposals put forward by the Pool Re Board.

Chapter 3

Mitigating the risk to the taxpayer of the unlimited guarantee

3.1 Pool Re's reserve funds have built up over time and, combined with its own reinsurance, enable it to independently manage losses stemming from a very large conventional (blast) terrorist attack.

3.2 However, extending an unlimited guarantee to Pool Re still represents a major contingent liability for the government and a material fiscal risk. A series of attacks or (following the expansion of the scheme in 2002) a non-conventional event, continue to represent a significant tail-end risk to taxpayers. There may also be further costs to HMG in response to a very large attack e.g., medical, and clear-up costs which could have an impact at either a national or regional scale.

3.3 As such, this review considered if the current guarantee continues to be appropriate and whether it represents value for money for the taxpayer. To do this it considered:

- **Market capacity for terrorism risk:** The market has developed significantly since Pool Re's inception and HMT policy is only to intervene in markets where there is an ongoing market failure.
- **Minimising HMT and the market's exposures:** HMT considered if the unlimited guarantee is necessary to meeting the aims of the scheme in terms of economic resilience and ensuring consumers can access comprehensive and affordable cover.

Market capacity for terrorism risk:

3.4 HMT first considered if there was market appetite to return the conventional (blast) terrorism risk back to the market and limit the unlimited guarantee to more extreme non-conventional terrorism risk. It was clear from the Call for Evidence, however, that stakeholders had significant concerns about the impact this would have on the market.

3.5 As a result of the unlimited HMT guarantee, Pool Re is exempt from Solvency II capital requirements. HMT therefore assessed what the capital implications would be for Pool Re if the unlimited guarantee was removed entirely or applied to only a subset of the risks it offered and how feasible this was.

3.6 An initial assessment by Guy Carpenter demonstrated that Pool Re's capital requirement for its conventional risk alone would be £12.5 billion using the

Standard Formula[1]. While an internal model approach to capital calculation could significantly lower this estimate, in the absence of the unlimited guarantee for both conventional and non-conventional terrorism risk, Pool Re's reserves would still not be sufficient to maintain its solvency.

3.7 Finally, HMT explored if Pool Re could purchase further reinsurance to meet this potential shortfall in capital. Pool Re has demonstrated that it is taking full advantage of commercial reinsurance markets; it currently has £2.5 billion of reinsurance, the largest terrorism reinsurance programme of any organisation globally. Respondents to the Call for Evidence were keen to highlight that international reinsurance markets will be highly sensitive to risk levels and availability of affordable capital would decrease following a loss event. As such, even if more cover could be purchased at this point, it would not be sustainable for Pool Re to rely on reinsurance rather than the HMT guarantee.

Minimising HMT and the market's exposures:

3.8 Several schemes internationally manage the fiscal risk to the guarantor government in two ways. Either through capping the level of funds they will pay out under the guarantee and/or excluding the most extreme risks from the guarantee (namely nuclear terrorism) to reduce the contractual fiscal obligations of the scheme.

3.9 HMT explored the possibility of capping its guarantee of Pool Re at both £30 billion and £100 billion. As set out earlier in this chapter, any action that revoked Pool Re's Solvency II exemption would have an adverse impact on the availability and affordability of terrorism insurance cover. It was therefore important to explore if a cap could be compatible with an ongoing Solvency II exemption. This was theoretically possible; the Solvency II exemption could continue so long as Pool Re capped its own liabilities in line with the value of the guarantee. This would ensure it could, with certainty, always meet its obligations. This could be achieved in one of two ways:

- Limiting the amount of cover sold by Pool Re to the total sum of its own reserve funds, reinsurance and the size of the capped HMT guarantee;
- Pool Re selling reinsurance cover, and by extension its members selling insurance cover, that entitled the holder to a portion of a limited fund. This method is used by a number of capped schemes internationally.

3.10 Limiting the amount of cover sold by the scheme would undermine Pool Re and HMT's aim of ensuring sufficient coverage of terrorism insurance and increasing businesses economic resilience against future threats. Selling policies which entitled the holder to only a portion of a limited fund also raised concerns:

- The scale of eligible claims may not be immediately clear following an eligible event and the process for calculating and paying out on an eligible claim could be arduous and lengthy.

[1] The Standard Formula is one of two approaches firms may use to set capital requirements. Under the Standard Formula firms undertake prescribed calculations to determine their capital requirement.

- This would create a significantly more complex insurance product for consumers which may not provide them with the funds they need in a time of crisis and could impact uptake.

3.11 Excluding nuclear risk from the scope of the scheme would reduce HMT's formal exposures to the most expensive threats but there were challenges with this approach. There is a very little, if any, nuclear terrorism cover available through the private market and having comprehensive terrorism insurance cover has become a pre-requisite for many investors. Excluding nuclear risk from the scheme would mean that HMT was no longer remunerated for this type of event but, as it would not be possible to buy cover to protect against this risk, leave businesses economically vulnerable.

Findings:

The current unlimited HMT guarantee of Pool Re remains important to the provision of terrorism insurance in Great Britain. It also poses a significant fiscal risk to the government, making it essential that taxpayer interests are protected. HMT will continue to provide an unlimited guarantee subject to:

- Pool Re proactively returning risk to the market (Ch. 4 & 5).
- Pool Re not paying special dividends or otherwise reducing its reserves without HMT permission.
- HMT ensuring funds on the public accounts are used appropriately by taking a power of statutory direction over public sector bodies benefiting from a guarantee or arrangement under the relevant legislation (subject to Parliamentary approval). (Ch. 8).

Chapter 4

Modernising Pool Re's system of reinsurance

4.1 Since its inception, Pool Re has operated a facultative (obligatory) system of reinsurance. Under this model, prices are based on four basic geographical risk zones. Reinsurance prices therefore do not always appropriately reflect the risk, and this is reflected in the pricing that is offered to businesses.

4.2 Pool Re has developed a more advanced model for terrorism risk based on the collection of significantly more detailed geospatial data. They have proposed that following the review, Pool Re should move to a treaty system of reinsurance given the advantages associated with the use of this model.

4.3 This change would be a world first for a government backed terrorism reinsurer and HMT agrees that there are two key benefits in taking advantage of further advances in the modelling:

- Utilising the model would enable more risk reflective reinsurance pricing. Whilst this is currently based on location, in future it could allow for other risk variations to be captured e.g., building materials.
- The treaty system would require Pool Re's insurer members to have access to elements of the model that would enable them to calculate their portfolio exposures. This would increase their responsibility for their whole portfolio of terrorism risk rather than simply ceding on a risk-by-risk basis. These steps are fundamental to delivering further market normalisation in the future.

4.4 The Call for Evidence was largely supportive of the change. Some insurers however valued the current simplicity of the scheme and expressed concerns for the significant proportion of the property and business interruption insurance market that used the Standard Formula to calculate capital requirements. The transition to a treaty system of reinsurance could be less intuitive for these firms than for those already undertaking more complex inhouse modelling. If not administered carefully, changes requiring insurers to take on more responsibility for terrorism risk could prompt some to withdraw from the market, reducing the availability of cover.

Findings:

Subject to the development of an appropriate proposal including the change being manageable for all firms, Pool Re has permission to move to a treaty system of reinsurance, under which the current underwriting manual would be removed and instead Pool Re would provide its members with portfolio pricing and access to a model based on more detailed and accurate geospatial data.

Chapter 5

Transferring risk back to the market

5.1 Pool Re's insurer members retain the risk and premiums associated with the first tranche of terrorism insurance losses (see Annex A). This retained risk currently amounts to £420 million. As part of this review, HMT considered if there was scope to increase this, thus further distancing the taxpayer from this risk.

5.2 Both Pool Re and the Call for Evidence identified the current practice of treating all forms of terrorism risk as identical for the purposes of member excess levels as the limiting factor in increasing them. They assessed that while Pool Re's insurer members would likely be willing to take on additional risk associated with conventional (blast) terrorism, any move to increase their non-conventional terrorism exposures would prompt them to de-risk (i.e., stop writing or write less terrorism cover).

5.3 Pool Re has asked HMT to agree to a change in the scheme's structure to allow risk to be bifurcated into conventional and non-conventional risk, enabling increased excess levels of conventional risk only.

5.4 Members retaining more conventional terrorism risk would further distance the taxpayer from the risk. All claims on the Pool Re scheme to date have been because of conventional terrorism events. Having more of this risk retained by the market would align with HMT's principle of only intervening when it is necessary to maintain the availability of cover. As such, HMT is supportive in principle of Pool Re's request.

5.5 However, facilitating this change will require wider changes to the scheme to ensure that the taxpayer continues to be appropriately remunerated for the risk it bears. The current basis of premium and investment income allocation between Pool Re and HMT was not designed for the process of returning conventional risk to the market. An increase in the conventional risk excess level of Pool Re's members would rapidly reduce HMT's remuneration but has little impact on the tail-end risk to taxpayers.

Findings:

HMT has asked Pool Re to develop a detailed and specific proposal on the bifurcation of member excess levels to enables its members to retain more conventional terrorism risk. HMT approval will be contingent on any reduction in taxpayer remuneration reflecting a proportionate reduction in risk.

Chapter 6

Promoting healthy competition in the market

6.1 The review considered if the two 'anti-selection' scheme rules in place since Pool Re's inception continue to be necessary. These are the 'Cede All Business' rule which requires insurer members to cede all of their risk to Pool Re and the 'All or Nothing' rule which requires the insureds of Pool Re's members to buy cover against terrorism for all (or none) of their locations.

6.2 The purpose of these rules is to ensure that the scheme benefits from covering a diverse array of risks. This avoids a situation where the market retains the liability and premium for the easiest to model and manageable risks and leaves the scheme, and by extension the taxpayer, with the bad risks in the overall portfolio.

6.3 In 2004, the Office of Fair Trading undertook work which found this rule would prevent the emergence of competitive terrorism reinsurance offerings but was defensible on the basis that without it, there would be adverse selection against the scheme[1]. In addition, there were no other significant market offerings. The review explored if this continues to be an appropriate assessment, or if the rules were now actively supressing the emergence of an alternative market for terrorism risk by requiring firms to use Pool Re to retain cover for tail end risks where in reality the private market could handle most risks.

6.4 The review has found little evidence that the rules are supressing the emergence of an alternative market for terrorism risk. Responses to the Call for Evidence reiterated that they have the support of the market, including other reinsurers, who agree these are standard market practice. No respondents asked for the rules to be removed.

6.5 The scheme rules also play a role in protecting taxpayer interests, both in ensuring the diversification of the scheme and as the removal of the scheme rules has the potential to undermine the scheme's ability to repay any future loan extended under the guarantee.

[1] CA98 decision - Pool Reinsurance (publishing.service.gov.uk)

Findings:

The review found that the anti-selection scheme rules, in place to avoid the private market cherry-picking the best polices and ceding the worst risks to the scheme, are not inhibiting the development of a private market and remain important to protecting the interests of the scheme and by extension taxpayers.

Chapter 7

Increasing SME uptake of terrorism insurance

7.1 Respondents to the Call for Evidence estimate that only c.10-20% of eligible businesses buy terrorism insurance cover, and that this figure is lower for SMEs in non-metropolitan areas[2]. The lack of uptake reduces the resilience of individual businesses and the wider economy to terrorism risk.

7.2 HMT maintains that it would be unprecedented to mandate either businesses to buy this cover or insurance brokers to offer individual lines of cover. There are no lines of insurance to protect one's own property or profitability that are compulsory in the UK.

7.3 However, HMT agrees that more can be done to address the low coverage. Industry bodies suggested that SMEs are not aware that insurance against losses from terrorist attacks must be purchased commercially, nor of the full benefits of that cover. Pool Re is aware of this issue and in 2019 it invested in a joint project with the UK National Counter-Terrorism Police HQ and the Home Office's Joint Security & Resilience Centre, with the aim of helping businesses to understand better the threat and how to manage and mitigate the risk of terrorism proactively.

7.4 SME representatives also agreed with Pool Re that its reinsurance prices translate into prices that are comparatively high relative to other risks linked to commercial property and business interruption. Pool Re require HMT permission to amend its pricing.

Findings:

With the support of HMT, Pool Re has agreed to reduce overall scheme pricing by 20%, with individual zonal reductions allocated based on model output, which will allow the industry to make cover more affordable. HMG and Pool Re will collaborate to address a lack of awareness amongst SMEs about the availability and benefits of cover, utilising and building on the Information

2 www.gov.uk/government/publications/hm-treasurys-review-of-pool-reinsurance-company-limited-2020-2022

Chapter 8

Meeting the expectations of Parliament

8.1 Pool Re operated as a private company from its inception in 1993 until early 2020, when the Office for National Statistics (ONS) classified Pool Re and concluded that it sits in the Central Government Subsector. The classification was a result of the controls HMT has over Pool Re, in place as a result of the guarantee it extends to it.

8.2 Whilst the ONS classification is for accounting purposes only, HMG policy is to apply appropriate controls to bodies classified in such a way. The classification does not impact the ownership of Pool Re's assets, which continue to be owned by the scheme and made available for the payment of terrorism insurance claims.

8.3 To balance the classification with Pool Re's specific circumstances, HMT has opted to implement HMG controls in a way that appropriately utilises the available flexibility of the framework. Pool Re has agreed to implement a Framework Document which sets out appropriate controls and practices for a body classified to central government. This includes a commitment to follow HMG's Managing Public Money guidance and implement appropriate reporting and accounting standards to facilitate the consolidation of Pool Re into the HMT group accounts (to be implemented from financial year end March 2023)[1].

8.4 Framework Documents are not legally binding, and this could put the Board of Pool Re in a difficult position in the very unlikely situation that they perceive a conflict between the Framework Document and, for example, fulfilling their other responsibilities. Equally HMT has an obligation to ensure Parliament's expectations on the appropriate use of public funds are met. To avoid this situation and provide clarity on all sides, HMT is seeking a power in legislation to make directions as necessary, in relation to the scheme.

[1] Managing Public Money, HM Treasury.

Findings:

Subject to Parliamentary approval, HMT proposes to amend the Reinsurance (Acts of Terrorism) Act 1993. This would give HMT Ministers the power to direct any public sector body extended a guarantee, or benefiting from an arrangement, under the Act to comply with relevant HMG controls aimed at ensuring they meet the expectations of Parliament.

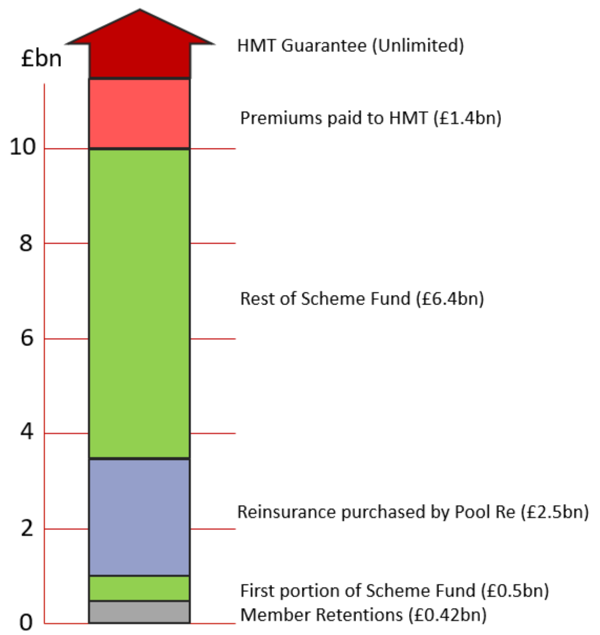
Annex A

Origins and structure of the Pool Re scheme

Pool Reinsurance Company Limited (Pool Re) is a mutual company that was established in 1993 following a series of terrorist attacks in Great Britain which led to reinsurers withdrawing from the terrorism insurance market. The Government's unlimited guarantee of the scheme (a commitment to extend a repayable loan if needed) meant that insurers were able to access adequate and affordable reinsurance cover for terrorism losses.

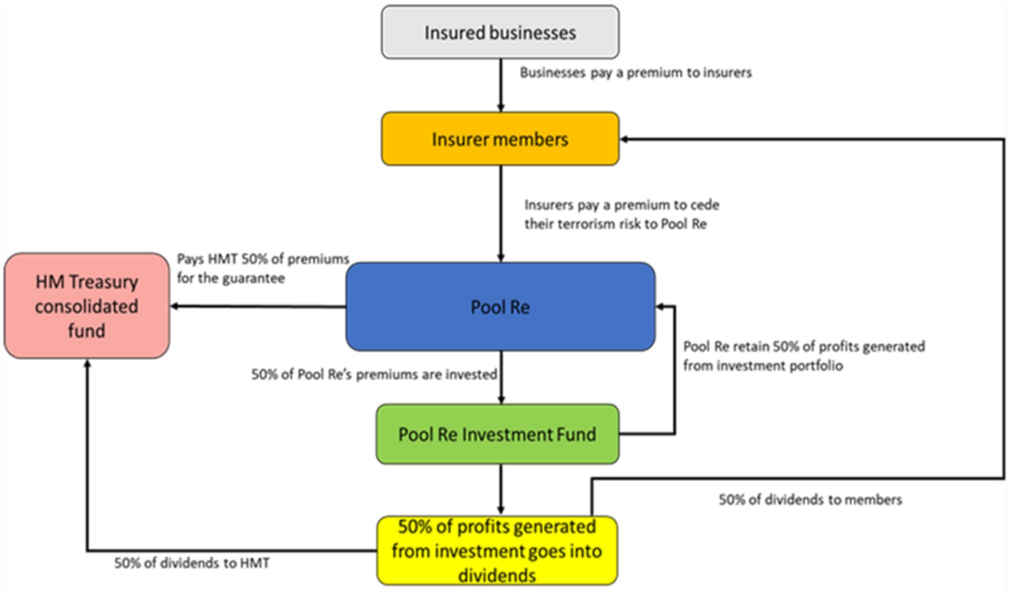
Pool Re is a mutual company. Its members (c95% of UK commercial property insurers) reinsure their terrorism risk with Pool Re for a premium. Following a terrorist event, members must cover a portion of the cost (member excess levels) before recourse to the scheme. Pool Re invests the member premiums it receives, and its scheme funds now holds in excess of £6.9 billion. Pool Re has also bought its own reinsurance. This, along with member excess, serves to distance the taxpayer from potential costs. Pool Re could now absorb losses of up to £9.5 billion before recourse to HMT, and £11 billion before the guarantee is engaged. Box 1.A illustrates the hierarchy of obligations, should a claim be made.

Box 1.A: Hierarchy of obligations for claims on Pool Re



Pool Re pays part of its premium (C.50%) and return on investments (C.25%) to HMT in return for its guarantee; £270 million in 2019 and £1 billion net to date. A portion of these funds are held to Pool Re's credit and would be returned to Pool Re should a significant event exhaust its own funds. Following this, HMT is committed to extending a repayable loan of an unlimited amount to Pool Re. Pool Re also pays 50% of its investment income to its insurer members in the form of a dividend. See box 1.B two on the flow of funds.

Box 1.B: Flow of funds



Pool Re needs HMT permission to undertake certain actions, including amending its underwriting manual. The commercial relationship between HMT and Pool Re is governed by the Retrocession Agreement, a legal document which can only be amended by mutual agreement.

In February 2020 the Office for National Statistics (ONS) classified Pool Re to the Central Government Sub-sector; the classification is retrospective to the scheme's inception. The details of this are set out in Chapter 9: Meetings the Expectations of Parliament.

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This document can be downloaded from www.gov.uk

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