

Changes to the Pool Re Scheme

Summary paper

1. Background

Following September 11, terrorism reinsurance and insurance cover was withdrawn across significant areas of the insurance industry. This was a particularly acute problem for commercial property insurance, where Pool Re provides reinsurance cover for commercial property damage and business interruption costs resulting from an act of terrorism which causes fire or explosion, but it does not provide cover against other forms of terrorist attack.

In response to representations from industry which expressed grave concerns about the gap between Pool Re cover and that provided by reinsurers, the Government agreed to discuss possible changes to Pool Re under the Terms of Reference at Annex A. The discussions would cover a range of issues which could be addressed without the need for primary legislation.

A working group was established under Treasury chairmanship involving representatives of the Association of British Insurers, the British Insurance Brokers Association, the Association of Insurance and Risk Managers in Commerce (AIRMIC) as buyers of commercial property insurance and Pool Re itself. This group has met regularly to try to develop a package of measures which meet the Terms of Reference. These negotiations have now produced broad agreement on a package of measures which aim to address the industry's concerns as well as taking account of changes in the market since Pool Re was set up in 1993.

2. Extension to Pool Re's cover

Pool Re currently covers commercial property damage and business interruption costs arising from an act of terrorism which results in fire or explosion. This means that an act of terrorism resulting in other causes of damage (eg a major flood or contamination) but which did not involve fire or explosion would not be covered by the current Pool Re scheme.

September 11 demonstrated that terrorists could find methods of attack which go beyond “normal” scenarios and the uncertainty which surrounds the method chosen by a terrorist is a source of great concern for insurers and buyers of insurance.

Cover provided by Pool Re will therefore be extended to cover terrorist attacks which cause commercial property damage and consequent business interruption by “all risks”.

There will be no change to the existing exclusion for war risks, nor to the type of property covered by Pool Re. There will however be an exclusion in respect of hacking and virus damage to electronic components due to the likely inability to prove a virus was a terrorist attack. It is intended that the present exclusion which exists under the scheme for damage caused by nuclear devices will be deleted as soon as practicable.

The extension in cover to all risks will be reflected in a doubling of the existing rating charged for Pool Re cover under existing Heads of Cover arrangements until the end of the year. (The rating is currently discounted at 85%, and this proposal does not affect that discount).

3. Retention

Pool Re currently operates a “retention” under which insurers bear the first amount of any claims for an event covered by Pool Re, for each “head of cover”, i.e. section of policies they issue. This retention is generally £100,000 per head of cover (though different retentions apply in certain circumstances). This means that the total cost borne by an individual insurer depends on the number of heads of cover affected.

The Terms of Reference emphasised the objective of encouraging competition within the market, given the fact that Pool Re is the dominant provider of terrorism reinsurance in this sector. In the current market, the scope for commercial capacity to re-enter the market is clearly limited. The most practical way of encouraging commercial capacity back into the market will be to raise the retention, opening the possibility for insurers to seek commercial reinsurance to cover these retentions.

The group believed a big increase in the retention would be difficult for insurers (particularly small insurers) to bear, particularly given the proposal that cover provided should be extended to “all risks”, since the current basis for the retention could lead to a very high overall loss for an individual insurer. The group therefore considered alternative models for the retention, and concluded that it should move to a **per event retention, combined with an annual aggregate limit** for each insurer, based on the overall terrorism market share of each insurer.

The intention is that the retention will be set for each insurer annually as a proportion of an “industry wide” figure. This will make a larger retention easier to bear for insurers, because they will have certainty about their maximum exposure in any one year, leaving Pool Re and if necessary the Government to bear the cost of a major incident or a terrorist campaign involving a sustained series of incidents.

In contrast to the old basis, each insurer will have its losses capped under the new basis, both per event and per annum. Insurers will know in advance the maximum amount they could be called to pay out in any one year.

From 1 January 2003 the maximum industry retention will be set at £30 million per event, with individual insurers’ retentions being based on market share. Extensive modelling work done on behalf of the group suggested this represents a moderate increase on retentions under the old basis (£100,000 per head of cover per policy).

Over the next four years it is intended that the retention will increase steadily, bringing commercial reinsurance in to cover insurers’ retentions or permitting insurers to retain this element of risk themselves. This increase will be phased in order to allow the market to get used to the new arrangements gradually, and to allow substantial time for the reinsurance market to re-establish terrorism capacity following September 11 2001.

The intention is that the *maximum* industry retentions set for the next four years will be as follows:

Applying from:	Per event	Per annum
1 January 2003	£30m	£60m
1 January 2004	£50m	£100m
1 January 2005	£75m	£150m
1 January 2006	£100m	£200m

In practice, the actual amount of retention borne by the industry following an event would probably be considerably less than this, depending on the distribution of claims between insurers.

4. Reinsurance and Insurance Premiums

The way in which Pool Re charges for its reinsurance will be reviewed to take account of the change in the basis and size of the retention for insurers.

Under the new arrangements from 1 January, insurers will be free to set the premiums for underlying policies according to normal commercial arrangements.

From 1 January 2003, the following arrangements will be discontinued:

- arrangements under which Pool Re may call additional premium from Members in respect of years which result in loss to Pool Re
- payment of premium rebates in respect of years which result in a surplus
- payment of reinsurance commission to Members.

5. Governance

The working group proposed a set of objectives (at Annex B) which it believed summarised the aims of the Pool Re scheme as a whole.

Pool Re and HM Treasury have agreed that as part of the overall package of changes to Pool Re they will re-examine the detailed involvement of Treasury in day-to-day decisions. Under the new arrangements the Public Interest Director will provide a formal annual report to the Treasury on how Pool Re

has performed against the objectives at Annex B. He may report more often than once a year in exceptional circumstances, and will bring to Treasury's attention any issues which arise which have a particular bearing on the objectives or some other aspect of the public interest.

6. Transitional arrangements

These changes will involve considerable operational changes for Pool Re and insurers. The detail of the changes will also be subject to further discussion between insurers, insureds, brokers, Pool Re and Treasury. Treasury will also discuss the changes with the Office of Fair Trading.

However, given the problems faced by insureds who are having to cope with gaps in their insurance cover for terrorism, it is essential that the extended cover should be implemented as soon as possible. The package will therefore be implemented in stages as follows:

- Once formalities are completed the present restrictions in the Pool Re scheme to fire and explosion only will be deleted. The wider "all risks" cover will apply to renewals from then. Premiums for the extended cover will be calculated at double the premium on the existing basis. In addition, Pool Re Members will be able to offer the extended cover as an optional addition to policies which have full terrorism cover in force. Insureds will choose whether they wish to have their policies extended or not. If they wish to do so they may backdate the extended cover to any date from 1 January 2002. In this case an appropriate "pro rata" premium will be charged for the period on risk.
- The Nuclear exclusion clause will be deleted as soon as practicable. This will be at latest 1 January 2003.
- The rest of the changes to the scheme mentioned in this announcement will be put in place from 1 January 2003.
- These changes will be reviewed as appropriate in the light of changing conditions in the insurance and reinsurance markets.

- The retrocession agreement and supporting documents will be amended to reflect these changes as appropriate.

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ANNEX A:

TERMS OF REFERENCE FOR POOL RE NEGOTIATIONS

The Government recognises there are circumstances in which it has a role as reinsurer of last resort to prevent or mitigate market failure: where there is a substantial public policy interest in pooling risk, and where the market is currently unable to provide insurance. It will not step in wherever the market does not offer cover.

In this case, there are issues for the insurance of commercial property for material damage and business interruption in the event of terrorist attack, for perils other than fire and explosion. In order to find a mutually acceptable way forward the Government will discuss with the industry changes to the Pool Re scheme to reflect the situation post September 11 and changes in the market since Pool Re was set up in 1993.

Discussions with the industry will cover:

- Extending Pool Re to cover additional perils for commercial property damage, within existing legislative boundaries.
- The way Pool Re is financed. Issues to be addressed will include premium rates, thresholds for industry participation and ways of accessing commercially available terrorist insurance capacity. This will be with a view to encouraging competition in the insurance and reinsurance markets and protecting customer's interests.
- Considering other ways in which the public (including consumer and taxpayer) interest can be reflected in the Pool Re arrangements, in particular through the governance of Pool Re.

Any solution must be practical; be commercially and economically viable; it must respect the taxpayer and consumer interest and should encourage the re-entry of commercial reinsurance into the market.

Discussions will be undertaken with a view to any solution being applicable to liabilities arising on or after 1 January 2002.

ANNEX B

POOL RE OBJECTIVES

Proposal by working group

Background

Pool Re exists to provide reinsurance cover, in the face of ongoing terrorist threat, where the market will not do so, and where this market failure would threaten the ability of British industry to function in the absence of Pool Re.

Objectives

Pool Re seeks to do this at reasonable cost, in respect of loss or damage to property located in Great Britain (and consequential losses), resulting from or consequential upon, acts of terrorism. In doing so it seeks to ensure (subject to the Retrocession Agreement, the various Reinsurance and other Agreements, and its other legal and regulatory obligations), that:

- (a) it achieves a reasonable level of equity of treatment of, and contribution from, insurers whose risks it covers;
- (b) its arrangements and practices do not unduly inhibit other commercial suppliers of reinsurance from entering or operating in the market, for example by ensuring that premiums reflect Pool Re's operating risks; and
- (c) it secures an appropriate balance between the interests of those who bear the financial risk, and in particular the ultimate stakeholders (insureds, members and taxpayers).

Constraints on Pool Re

The Governance arrangements which support these objectives must acknowledge the legal and regulatory responsibilities and limitations of the Pool Re Board.