POOL Re
REINSURING TERRORISM RISK

Protecting the future

Member Consultation

Foreword

Pool Re was established in 1993 following the private insurance market's decision to withdraw capacity for terrorism cover in response to the IRA's bombing campaign in mainland Britain. Nearly three decades on from the market failure which necessitated Pool Re's creation, terrorism is a far more complex and potentially more catastrophic risk, but one for which there is a large and competitive insurance market to meet the needs of policyholders and anchor the UK's economic resilience. Terrorism is no longer an uninsurable peril because insurers and politicians partnered to create a model which allowed them to share a risk which neither could address alone or afford to remain unresolved. Since 1993 Pool Re has successfully re-established and grown a private market for terrorism which today protects assets worth £2.2trn, from shopping centres and local traders to airports and power grids, across sectors of the economy such as real estate, retail, transport, construction and energy.

Central to Pool Re's success over the years has been its capacity to evolve as the threat of terrorism has changed and as the insurance industry has modernised. HMT's recent 5 year review of Pool Re confirmed the retention of its unlimited financial guarantee, which sits as the cornerstone of our scheme, but only on the basis that Pool Re continues to evolve and find ways of proactively returning risk to the market. Alongside our mandate to return risk, and thereby distance the taxpayer from the economic consequences of terrorism, we are also mandated to find ways to increase awareness and penetration of terrorism insurance cover across the UK's SME community to better safeguard the resilience of the British economy.

These twin objectives – driving greater SME penetration and returning risk to the market - inform the proposals which we are now consulting our Members on. The switch to a treaty reinsurance model would be the most significant change to our scheme in its history. It should not only simplify the way in which our scheme operates and bring it into line with an increasingly digital marketplace but, crucially, it should also give Members the flexibility to price terrorism cover for their policyholders as they see fit. And it is hoped the latter would encourage the reincorporation of terrorism into standard property policy wordings, for little or no extra cost, for exposures that do not materially impact treaty pricing, a move which could see many more SMEs protected up and down the country. The other key proposal is to bifurcate terrorism between conventional and non-conventional risk, to enable Members to increase retentions for conventional terrorism, thereby returning risk to the market, without taking on any additional exposure to cyber-triggered terrorism or CBRN.

We do not underestimate the magnitude of these changes and we recognise that they would take time to implement. Of course, if we are to progress them we must first have the feedback and views of our Members. That is why this consultation matters. I strongly encourage you to share your views openly and frankly so that we can move forward collectively, taking into consideration the issues that most concern our key stakeholders, to ensure that Pool Re's scheme remains fit for purpose for the years ahead.

T. Clementi

Tom Clementi
CEO Pool Re

Introduction

In 2020, Pool Re was classified by the Office for National Statistics (ONS) as a central government organisation and, subsequently, by the Cabinet Office, as an Arm's Length Body.

Fundamental to the review was our success in persuading HMT that the unlimited guarantee must remain a cornerstone to our scheme, and that any limit or cap would likely have an adverse impact on the insurance industry's ability to provide terrorism cover. HMT agreed and the guarantee remains in place.

Members were updated during a Members' Meeting, held on March 18th 2022, and asked to vote on an agreed 'Scope of Works' which sets out the actions Pool Re has been specifically empowered to explore in consultation with HMT over the next 5 years. Central to the Scope of Works is an objective to transition to a treaty reinsurance mechanism and amend the scheme retention structures in order to return risk to the market.

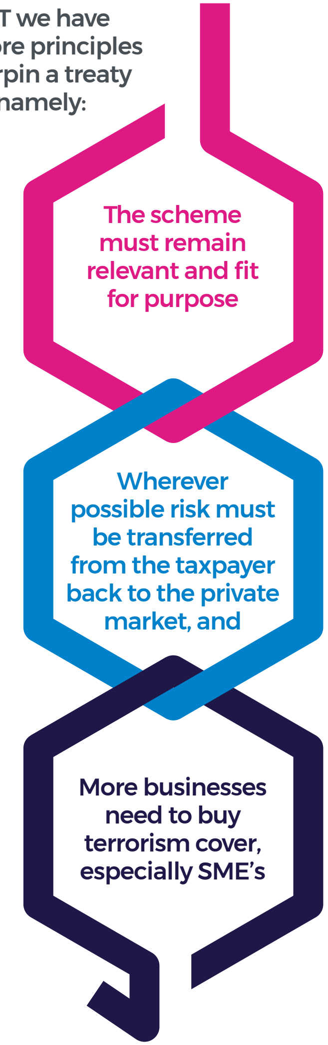
Reviewing the Pool Reinsurance scheme

Prior to the HMT review, with the backing of our Board and Member advisory groups, a decision was made to review our reinsurance framework and structure to ensure our reinsurance scheme was fit for the modern insurer and the changing nature of the terrorism threat.

We believe the treaty mechanism we are proposing will deliver a first-class reinsurance scheme and continue to provide the most effective and relevant cover for our Members. A treaty will provide more seamless account level protection to Members by:

- Providing cover through the type of catastrophe treaty structure most Members will already be familiar with.
- Bifurcating the risk, freeing Members to vary retention breakdown between the classes according to appetite. This will facilitate greater retention of conventional risk, and accelerate transfer of liability to the private sector.
- Freeing Members to set pricing within their own products and segments, allocating the cost of the treaty within their own strategy and risk appetite.
- Empowering Members to drive SME penetration. Significant increased premium would flow directly into the private market.
- Operating within a framework that is still broadly familiar for insurers, preserving the elements of the scheme that Members value.
- Enabling the integration of terrorism cover into digital distribution channels.
- Creating a more attractive environment for retrocession and Insurance Linked Securities.
- Removing bureaucracy and rules that impair policyholder take-up.

Together with HMT we have identified three core principles which must underpin a treaty type mechanism, namely:



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Background

Although some of the constituent elements of the scheme's mechanism, such as retentions, have changed since the scheme was created in 1993, many of the key fundamentals are unchanged since then. As an example, the premium tariff established in 1993 is today very similar structurally despite the rates themselves becoming a little more risk reflective in recent years.

Whilst this consistent structure has served Members well for 29 years, by contributing to Member IT environments, the scheme framework is now not only out of date but also incompatible with both the modern digital and regulatory insurance landscapes.

One element that has changed a number of times is the scope of coverage. In 1993 cover was restricted to damage caused by fire and explosion with the first change being introduced a decade later when cover was expanded to 'All-Risks' (including CBRN) in 2003. In 2018, the electronic exclusion was modified to provide cover for remote digital interference (cyber) and then in 2019 Class B coverage was created in order to grant standalone non-damage business interruption cover.

Scheme strengths

Breadth of Cover: Terrorism cover offered by Pool Re Members is effectively 'All-Risks' with the only exclusions being war and cyber, although cyber-terrorism resulting in damage is added back. This extended scope of cover, which uniquely includes CBRN to the full extent of the underlying sums insured/limits, is particularly relevant given the ever-changing nature of terrorism and the potential for unprecedented events.

Guaranteed acceptance: Membership of Pool Re is open to any authorised insurer. Where a Member Insurer provides property insurance, they must offer terrorism cover upon request. Cover and terms are not constrained by geographical accumulation or risk profile.

Capacity: Pool Re is backed by an unlimited guarantee from HM Treasury. This means that an Insurer who is a Member of the scheme can provide cover to all or any of their eligible policyholders who wish to buy terrorism. Importantly this cover would continue to be available even after a catastrophic terrorism event.

Back-to-Back with Property: Pool Re cover is back-to-back with the property policy given terrorism cover can only be written in conjunction with a commercial property policy. This means the definitions, exclusions and triggers are aligned which facilitates seamless cover between the property and terrorism policies. All claims, whether property or terrorism, are handled by the underlying property insurer.

Certification: There is an agreed process for an event to be certified by HM Government as an act of terrorism, underpinned by a binding tribunal process in the event of a dispute. Given the back-to-back nature of the cover, if an event is certified then it is terrorism but if it is not, then the exclusion on the property cover is not activated.

Competitive Premiums: Although it is for individual Members to decide on the premiums for each policyholder, the cost of reinsurance from Pool Re outside Central London will reduce by circa 20% from October 2022. Additionally, further discounts are available to incentivise certain forms of retained risk.

Risk Management Discount: In 2022 Pool Re has re-designed its VSAT™ (Vulnerability Self-Assessment Tool) risk management platform to improve navigability and streamline the question sets. In addition, the premium discount for eligible risks (TSI exceeding £50m) that meet the VSAT™ benchmark has been increased to 10% from October 2022.

Cover that meets the contemporary threat: In the 29 years since the scheme was created, the cover offered by Pool Re has been widened enormously. At its inception the scheme only offered fire and explosion, which was extended in 2003 to 'All-Risks' including CBRN and then widened further in 2018 to encompass damage caused by terrorism using remote digital interference. Finally, in 2019 legislation was passed in order to allow Pool Re to offer reinsurance for standalone non-damage business interruption.

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The current Pool Reinsurance scheme

The principal administrative elements of the current scheme are as follows:

1. An Insurer elects to join the scheme and becomes a 'Member'.
2. The contractual relationship between Pool Re and each Member is outlined in the Reinsurance Agreements.
3. As regards matters of scheme administration, underwriting and claims, the Reinsurance Agreements refer to the Underwriting Manual and stipulate that compliance with the Underwriting Manual is a condition precedent to liability.
4. Once an Insurer is accepted as a Member, reinsurance cover is automatically provided for any terrorism cover granted by the Member to a policyholder.
5. Where it relates to certain key matters, Members must comply with the Manual at individual risk level. This includes pricing, where the reinsurance tariff contained within the Manual must be applied to every risk ceded to the scheme, as regards the price paid to Pool Re.
6. Furthermore, key scheme rules, such as ceding every eligible risk and non-selection by policyholders, must be complied with and applied at policyholder level.
7. Class A premiums are paid by quarterly bordereaux, one month in arrears. Timely payment is a condition precedent, failing which a Member would see all reinsurance cover suspended until payment is made.
8. Exposure data is collected annually as of 30th June.
9. Member retentions are set annually once the market retention has been set by Pool Re. Each Member is allocated per event and an aggregate amount based on their share of scheme GWP in the preceding year.
10. Claims must be handled in accordance with the Underwriting Manual, more importantly amounts may only be recovered from Pool Re once payment has actually been made by the Member.

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Rationale for change

Pool Re has been discussing the idea of changing the way it provides terrorism reinsurance since 2018. This dialogue has involved Pool Re's Board, Member Advisory Groups, HMT and other key stakeholders such as reinsurers, business groups and insurance industry bodies. Pool Re made the case for change before and during the recent HMT review of Pool Re and now believes there is a broad consensus that change would help deliver a scheme fit for the contemporary insurance marketplace.

The case for making changes to the scheme mechanism after 29 years can be summarized as follows:
Rigid, rules based reinsurance conflicts with requirements of modern, digital marketplace.
Current simplified approach to pricing does not reflect terrorism risk nor members' retained risk. Pool Re is building a more sophisticated pricing model which will facilitate member retentions being increased as well as the possible creation of buy-down mechanisms.
HMT requires that risk be returned to the market wherever possible and this requires member retentions to be sub-divided (bifurcated) into conventional risk that can be privatised and non-conventional, where there is no private risk appetite. The current scheme mechanism cannot deal with this.
Current scheme rules and pricing tariff applied at policyholder level which is a barrier to increasing penetration, especially for SME's. Members need to be free to provide coverage across their portfolios without unnecessary bureaucracy or threats to account level reinsurance coverage.
Commercial insurance products are sold digitally and increasingly without the involvement of an underwriter or broker. If terrorism is to be re-integrated into package products it must be sold and underwritten in the same way.

Provided any issues that might be raised by the regulators or HMT can be dealt with, we believe that a modern treaty framework can provide the platform for Members to integrate the pricing and acceptance of terrorism into their products.

In the short term, changes will need to be made to Member systems to reflect the treaty mechanism, as well as the increased focus on modelling and pricing risk retained under the new arrangements. These changes may cause some additional cost of change in the short term but we believe this is necessary to deliver a scheme that is fit for both the modern insurance landscape and the contemporary threat.

Finally, we believe that doing nothing would lead to the scheme losing penetration as well as relevance given the current mechanism is outdated and does not provide the vehicle for returning risk to the private market, as is required by HMT.

Pricing

When the premium tariff was originally created in 1993, it was based on a simplified comparison of fire and explosion perils and did not involve any detailed assessment of the terrorism risk beyond the creation of rating zones. These 4 zones were based on the assumption that the IRA was mainly interested in targeting London and other urban centres. Over the next 15 years, as technology in the insurance industry became more important, the rating zones were hard wired into many insurer systems and propositions.

The 4 rating zones have existed since scheme inception but the actual reinsurance rates have changed many times since 1993. Until 2015 the changes were not informed by any actuarial or model output, given no model existed. Since 2015, Pool Re has been developing its modelling capability and has used this more risk reflective assessment to drive changes to its rating, whilst retaining the same rating zones.

However, the development of a Pool Re terrorism pricing model, which is expected to be completed in 2023/24, will facilitate a more detailed assessment of terrorism risk and thereby address the inherent flaws in the current scheme pricing.

Pool Re Terrorism Pricing Model

Price zones

Four price zones cannot reflect the geographical dispersion of terrorism risk in the UK.

Member retentions

The current approach to pricing does not directly take Member retentions into account and, as retentions have increased, and will continue to do so, will not reflect changes to the net retained risk by Members.

Modelling techniques

The deployment of more sophisticated modelling techniques in recent years, especially around CFD blast modelling and plume models for CBRN, provides the ability to distinguish between thousands of rating areas instead of just 4.

CBRN & Cyber

When the current price framework was created, the scheme did not provide CBRN or Cyber coverage.

Actuarial techniques

The pricing tariff structure was not created using the type of sophisticated actuarial techniques available today, rather it was a 'finger in the air' based on superficial peril understanding. It cannot provide the mechanism either for greater pricing dexterity or a treaty reinsurance solution.

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Transitioning to a modern treaty reinsurer

Should Pool Re transition to a treaty type mechanism, there will be a number of important changes to the way the scheme works.

However, the scope and extent of coverage will not change, cover will still be 'All-Risks' with only 2 exclusions which are war and cyber (with the cyber trigger add-back). Importantly, the extent of cover would remain unlimited in excess of the Member retention, which would hopefully, subject to the necessary dialogue, retain the favourable capital assessment treatment by the PRA.

What would change are the pricing methodology, ceding arrangements and scheme administration.

The principal changes would be:

The Underwriting Manual would no longer be required so all scheme rules and conditions would be contained in the Reinsurance Agreement.

There would no longer be a reinsurance premium tariff laying down the premium paid to Pool Re for each individual risk.

Reinsurance premiums would be calculated at Member portfolio level using the exposure data snapshot collected as of June 30 annually.

Subject to certain minimum thresholds, beyond this each Member will be able to decide their own level of retention under the treaty although this will be bifurcated (split) between conventional and non-conventional terrorism risk.

Like most catastrophe treaties, retentions will be set on an aggregated basis although there will be an inner limit to cap the exposure to non-conventional. The retentions will reflect a market retention allocated by Pool Re annually and will include a minimum level per Member, although Members are free to buy their retentions out either through a facility fronted by Pool Re or protect privately.

Premiums charged to each Member will reflect their individual retentions and the effect of these upon risk ceded to the scheme. As there will be a higher level of retention held by Members, there would be a commensurate increase in premium retained by Members.

Any Member buy-out facility would be optional and separate to the main treaty and use capacity from the reinsurance market for some or all of the exposure. The facility would be written on Pool Re paper and allow Members to buy-down to retentions similar to those in place now. Importantly this still facilitates the return of risk to the private market, we are merely offering those Members who do not wish to retain such risk access to other private capacity as well as the economies of scale in Pool Re placing in bulk through its existing reinsurance relationships.

Future pricing would be derived from Pool Re's pricing model, currently in final stages of development and ready for testing in Q1 2023. Initially an expected loss would be calculated using each Member's portfolio exposures which is likely to differ from the present simplified pricing approach. We need to evaluate our preferred approach to transition pricing as well as how we can retain some of the pooling principles that underpin the provision of affordable terrorism cover for all. This could involve implementation of cap and floor principles or the blending of a Member loss curve with the overall scheme curve. We would be interested in Member feedback on this point and indeed are consulting with other key stakeholders on this point to ensure we can comply with any competition law considerations.

Given this is a fundamental change in the way the scheme works, it is possible we will start the pricing on an adjustable basis where we price on the closest June snapshot and then adjust premiums based on the next snapshot.

Treaties will incept/renew on a certain date and as this is a mutual pool, the dates for all members will need to be closely aligned so as to avoid price movements. This may require us to 'lock' the model and renew all treaties across a 2 month period (ie Jan 1, Feb 1 and Mar 1) as otherwise Pool Re will face renewing 100+ treaties on the same day.

The key rules of the scheme will be reflected in the Reinsurance Agreement. 'Cede all business' is expected to remain unchanged and still require a Member to cede every eligible terrorism risk to the scheme. 'All or Nothing' is expected still to require a policyholder to buy terrorism for all their eligible property, but Members may feel some clarification to this might be helpful as regards SME to reflect digital trading.

Should they require it, Members will be able to access output from Pool Re's pricing model, in order to inform both their assessment and pricing of their retained risk.

Year one of the treaty arrangement will be a transition year given the run-off of coverage from the existing scheme.

Accounting would be simplified with payments of the treaty premium being collected in two or three instalments which mirrors the arrangements on most catastrophe treaties.

There would be no material changes to claims procedures although we will consult on one or two aspects.

Complete the consultation - poolre.co.uk/member-consultation

Consultation and Treaty timeframe

Consultation Document sent to all Members and other key stakeholders

Consultation discussions with Member Groups

Consultation Closes

Discussions commence with HMT, regulators and competition advisers

Pricing model discussions with Members and Peer review

Final Treaty proposal document issued to key stakeholders

Pricing model final testing and sign off

Buy-down facility proposal

Final treaty proposal issued and Members meeting convened for vote to approve

Members sign up to new arrangements and contracts signed

Treaty goes live

Aug 17

Sept/Oct

Oct 31

Q4 2022

Q1 2023

Q2 2023

Q3 2023

Q3 2023

Q4 2023

2024

Q1 or Q2 2025

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Consultation questions

Question 1

When HMT agreed to continue to provide an unlimited guarantee, they made it clear this was on the basis that Pool Re must continue to return risk to the private market. In effect this means that Member retentions must increase over time.

How will your Member organisation respond to this and what might you require to inform your view of terrorism risk?

Question 2

The feedback Pool Re has previously received from Members was that although there is appetite for conventional terrorism risk (blast), there is little or no appetite for non-conventional risk (CBRN/Cyber-terror). In light of this the retention structure is likely to be split so that only conventional retentions would increase.

Do you agree with this approach?

Question 3

We know that some Members already buy reinsurance to protect their current Pool Re retention. When retentions increase demand for such buy-down reinsurance will increase and it is unclear whether the private market has sufficient capacity for all.

Do Members think some form of buy-down facility fronted by Pool Re might be helpful in ensuring all Members have equal access to such reinsurance?

Question 4

As the reinsurance protection offered by Pool Re would, if approved become a catastrophe treaty, the protection on the main treaty will be aggregate excess of loss.

Do Members think this will help them to consider terrorism as a catastrophe risk and thus deploy their catastrophe risk appetite (as distinct from their risk appetite)?

Question 5

Some members may not be content to retain 100% of an increased retention, especially those writing large risks or multiple exposures in urban centres. The new treaty retention will be closer to that seen on natural peril Cat treaties.

Would your Member organisation want to close the gap between catastrophe and risk attachment points? If buy-down capacity was available that was similar to a risk treaty, whether from Pool Re or the private market, would this be of interest?

Question 6

Would Members indicate their views on the following illustrative structure below with aggregate retentions increasing by approximately 50%?

Illustrative Structure: Main terrorism treaty providing unlimited limit in excess of £650m annual aggregate retention across all Members. The buy-down risk facility (optional) to provide £400m in excess of 250m, with perhaps one reinstatement included. Pool Re would write 100% of the buy-down facility and then buy reinsurance for a significant proportion of that, thereby retaining the principle of returning risk to the private market.

Question 7

Were aggregate retentions to increase as suggested in Q12, what type of optional buy-down or risk event cover might Members like Pool Re to provide?

Should this be restricted to the ability to buy-down to current retentions or should it offer capacity below that?

Question 8

In the event that a treaty mechanism is adopted, pricing would no longer be on the basis of a simple tariff that applied to every risk irrespective of the Member writing it. Pool Re would price the Member portfolio, based on the annual exposure data snapshot, which would reflect the account exposures as well as the effect of the retention on losses to the scheme. This could then need to be blended with overall scheme pricing such that the price to each Member would contain an element of their exposure as well as a proportion of the whole scheme.

Do Members agree this might be a good way to retain the pooling principle?

If not, what alternative approaches could be considered?

Question 9

Pool Re is developing a pricing model that would be utilised to evaluate and quantify exposure to the scheme.

Would Members require access to model outputs to enable pricing of their retained risk and if so what would Members need?

Question 10

The return of risk to Members, as well as a greater portion of terrorism premiums, will inevitably lead to different Members pricing terrorism in different ways. Whilst the premiums charged by Pool Re will be based on the same model, Members will be free to vary the level of risk they retain, and to apply their own pricing. This will inevitably lead to greater competition in terrorism.

Will Members welcome this or are there concerns or issues we might need to consider?

Question 11

The change to a catastrophe treaty will not affect the scope or extent of the cover provided by the scheme. However it will change the way Members account to Pool Re and settle premiums. Similarly, it will make the exposure data the key element of the modelling and pricing, so data quality will become even more important. We have assumed we will need to allow at least 12 months from the date of any Member vote for transition from the current scheme, in order that Members can make the required changes to their systems.

Do Members feel this is sufficient?

Question 12

Will you require the assistance of your reinsurance broker in placing your terrorism treaty and/or buy-down cover with Pool Re?

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Consultation questions continued

Question 13

What factors might influence your assessment of whether to automatically embed terrorism cover in some of your commercial insurance products?

Question 14

Pool Re will discuss relevant matters with the regulators but do you think the FCA might consider the re-introduction of terrorism as a standard peril as 'bundling'?

Question 15

Businesses look to their insurer to provide financial protection against a broad range of risks and we are interested in how Members consider the provision of terrorism for SME's might be structured so as to encourage greater take-up.

Would you please provide your thoughts on this?

Question 16

HMT confirmed their view during the recent review that the 'cede all business' and 'all or nothing' rules remain necessary for the effective operation of the Pool Re Scheme.

Although treaty does not necessarily change this, we wonder if Members have any views on how the 'all or nothing' rule might be clarified to assist with greater penetration of terrorism cover, especially in the SME market?

Question 17

Under a treaty reinsurance model, would it be necessary or desirable for the way in which claims are dealt with to change?

If so, how and why?

Question 18

Are Members content with only being able to recover claims once they have been paid to policyholders?

Would some flexibility around particularly large payments be helpful and in what circumstances? (for example, when such payments might present cash flow challenges for the Member)

If so, please describe what flexibility might be beneficial.

Question 19

Do you think Class B (non-damage BI) cover should be kept separate to Class A cover or, if legally achievable, could it be integrated into the buy-back facility?

Question 20

Please provide your views on Class B in general terms, including your views on:

- Whether Pool Re should continue to offer cover and how; and
- The market around non-damage BI - with non-damage BI cover harder to secure from the property market, the prospect of Pool Re cover could being provided even when non-damage BI is not provided under the underlying property policy has been raised.

Question 21

Although the quality of exposure data provided by Members has improved enormously in the past 5 years, as the treaty mechanism will rely on this data to calculate Members' reinsurance premiums it is vital that Members can provide a consistent level of data as indeed they do for other catastrophe arrangements.

Can Members comment on how exposure snapshots can be further improved and if data quality should be recognised in the terms offered?

Question 22

Regarding the requirement for policyholders to insure all their properties for terrorism, with most SME policyholders binding wholly or partly electronically, do members think there are other ways the rule could be applied?

Question 23

Treaty premiums would be based upon exposure data submitted annually by each Member. As with any treaty the data snapshot is extracted at a point in time that is usually 6 months or more prior to the inception of cover, which means actual exposure will be different by that time. There is also the issue of transition between the current scheme and a new treaty.

There are a number of ways reinsurers commonly deal with these issues and we are interested in Members views in general as well as on a few specific points below. Members are asked to comment on which of the following options they consider feasible, and why?

- Year 1 Treaty premium set using data collected in prior year but premium adjusted at year end using next set of data.
- Premiums non-adjustable but year 1 premium adjusted to reflect run-off from existing scheme.
- Premiums non-adjustable provided exposure data does not move by more than x%.

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