Institute and Faculty of Actuaries

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HM Treasury Review of Pool Reinsurance Limited 2020-2021: Call for Evidence

IFoA Response

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

Key points

A number of factors need to be considered to determine whether the HMT guarantee of Pool Re remains necessary. A key factor is the appetite of reinsurers to take on the risk, as well as the desire and ability of direct insurers to retain the risk. The cost of terrorism (re)insurance could be expected to increase without HMT's guarantee, and this cost could impact affordability of the underlying insured parties. Potential consequences could then be to leave underlying parties electing to self-insure, or not to buy terrorism insurance cover. This could then be an issue for the stability of the economy following a terrorism event.

Another consideration is the ability of (re)insurers to model/ assess terrorism risks accurately. While progress has been made by (re)insurers in modelling terrorism risk, understanding the nature of such risks from an insurance perspective is still developing. Restricted access to government intelligence information makes it harder for insurers to model and hence price terrorism risks to a greater degree of accuracy.

The current (re)insurance model allows for some diversification between different types of terrorism attack. If conventional attacks were excluded from the Pool Re guarantee, it may reduce the scope for insurers to benefit from diversification. Lower scope to diversify risk tends to drive up the cost of insurance.

If Pool Re were subject to Solvency II regulation, then determining the corresponding solvency capital requirement could require significant judgement to assess the impact of the associated '1 in 200 year' terrorism loss. Given the current HMT review of Solvency II in the UK, it is worth considering what specific changes to Solvency II in a post-Brexit world would be desirable in relation to terrorism insurance.

Factors affecting the ability of insurers to retain more terrorism risk are wide-ranging, as terrorism losses could have significant and multiple impacts on the insurer's balance sheet. One key issue is that terrorism losses occur at low frequency but with potentially high severity; such losses are difficult to model given the (limited) track record.

Reducing reliance on Pool Re would lead to more private insurance participation, but there would then likely be a significant withdrawal following a major terrorism event. Experience following the attacks on the World Trade Center (2001) showed that insurers were unwilling to provide cover without government support.

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to HMT's Call for Evidence for its 2020-2021 review of Pool Reinsurance Limited. In developing our response, we have drawn upon input from members working in the general insurance market, either for insurers or insurance auditors/ advisors.

2. It is important to note that, as for any IFoA inquiry/ consultation response, we have considered the issues from the perspective of the public interest.

3. We have answered a subset of the Inquiry questions below, restricting our answers to areas where we have specific points to raise. We would be delighted to meet with the HMT to discuss our response in more detail, if HMT considers this useful.

Q1: 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?

4. A number of factors need to be considered to determine whether the HMT guarantee of Pool Re remains necessary. A key factor is the appetite of reinsurers to take on the risk, as well as the desire and ability of direct insurers to retain the risk. The cost of terrorism (re)insurance could be expected to increase without HMT's guarantee, and this cost could impact affordability of the underlying insured parties. Potential consequences could then be to leave underlying parties electing to self-insure, or not to buy insurance cover for terrorism cover. This could then be an issue for the stability of the economy following a terrorism event.

5. Another factor is the ability of (re)insurers to model and assess terrorism risks accurately. While progress has been made by (re)insurers in modelling terrorism risk, understanding the nature of such risks from an insurance perspective is still developing. Restricted access to government intelligence information, whilst understandable, makes it harder for insurers to model and hence price terrorism risks to a greater degree of accuracy.

6. It is also worth bearing in mind that HMT's guarantee could possibly need to be reinstated in the event of significant industry losses which deplete the resources of Pool Re. This may be necessary to prevent a significant contraction in capacity.

7. If economic instability were to occur following a terrorism event, it is also plausible that HMT could eventually meet much of the resulting cost - i.e. in effect by being the insurer of last resort. In this scenario, it may be more expensive for HMT overall compared with the cost of supporting Pool Re, if there were no insurance cover at all. Conversely with insurance participation, (re)insurers would obviously pick up some of the cost.

8. It is also worth noting that, in general, it is cheaper and more effective to support disaster recovery via insurance rather than through direct support from government. This may also be the case in respect of terrorism losses: insurance terms and conditions enforce better risk management, and claim payment may be faster and more efficient where organised by insurers.

9. A further factor relevant is the ability to spread risks, which could be impacted by the demand and take-up rates of terrorism cover. For example, many developed countries offer some form of government-backed terrorism scheme. This makes spreading of risk difficult on a global basis. Therefore, if terrorism insurance policyholders are mainly larger UK organisations, then there is less opportunity for (re)insurers to spread or diversify their exposure to terrorism risk, including exposure from small/ medium organisations or retail customers across the globe. Lower scope to diversify risk tends to drive up the cost of insurance.

Q2: 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.

10. We have a number of points in relation to the 'splitting' of the market referred to. The current (re)insurance model allows for some diversification between different types of terrorism attack. By not including conventional attacks within the Pool Re guarantee, it may reduce the scope for insurers to benefit from diversification. In addition, the private market may not want to insure solely conventional attacks, again due to less diversification between different types of attacks.

11. There is then a question of fairness or perceived fairness; it may be considered unfair if some businesses were not covered due to the loss being from the 'wrong' type of terrorism attack. For example, multinational companies are perhaps more at risk from cyber terrorism than smaller companies. Similarly, smaller companies are perhaps more at risk from conventional terrorism. So if Pool Re provided only cyber and CBNR cover, then they would largely be covering multinational companies.

12. A converse point is that if conventional terrorism attacks were considered less likely now, then it is plausible that (re)insurers would be more willing to provide cover for such attacks.

13. It is also worth considering an issue which has been highlighted by the ongoing COVID-19 pandemic. There has been much industry debate over whether relevant insurance policies included cover from losses arising from COVID-19, such as on Business Interruption insurance. This issue has highlighted the importance of clear insurance policy wording, including clarity over what is covered and what is not. This would be relevant to terrorism (re)insurance were the market to be split as suggested in this question.

14. A further COVID-19 related point worth noting relates to home insurance. In the light of the pandemic, the distinction between 'home' and 'office' is becoming blurred. One potential difficulty is that whilst offices may be covered for damage and business interruption from terrorism acts, an office at home tends not to be: typically, home insurance policies exclude terrorism cover.

Q4. 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 capital requirement. How would this impact on the availability and affordability of terrorism insurance?

15. If Pool Re were subject to Solvency II regulation, then determining the corresponding solvency capital requirement could require significant judgement to assess the impact of the associated '1 in 200 year' terrorism loss. Holding such a capital requirement *could* adversely impact the required premium, potentially making terrorism insurance less affordable. Coming within scope of Solvency II could also potentially increase policy expenses. A counterpoint though is that Pool Re (currently) has a very strong balance sheet, so it may have less need to strengthen its capital position to meet Solvency II capital requirements.

16. The SII market risk capital requirement could encourage changes in asset portfolio which could be incompatible with Pool Re's objectives, given how aspects of Pool Re are atypical for a general insurer. For example, from Pool Re's 2019 annual report, it had equity holdings of £1.1bn, out of £7.0bn of total assets.

17. There are however elements of governance under Solvency II that might be beneficial for Pool Re to follow, including the emphasis on risk management and solvency assessment. There are also

aspects of Solvency II financial reporting which the general public might be useful. If the terrorism insurance market were opened up, then being subject to Solvency II regulation would be help create a level playing field between participants in this market.

18. Given the current HMT review of Solvency II in the UK, it is worth considering what specific changes to Solvency II in a post-Brexit world would be desirable in relation to terrorism insurance.

Q5. 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?

19. Although we do not have a change of guarantee to propose, we suggest that if any risks are transferred back to the market, this transfer should take place on a gradual basis. A gradual shift could make it easier for market participants to develop their capabilities over time in relation to terrorism insurance/ risk management.

Q6. 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.

20. Increasing members' retentions may make some insurers less willing to take on the risk. Although this would almost certainly result in increased costs for the underlying insured parties, the impact may be small depending on the size of the increase in retention and how much each firm currently provides as cover, relative to their retention.

Q7. 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?

21. Factors affecting the ability to retain more terrorism risk are wide-ranging, as terrorism losses could have significant and multiple impacts on the insurer's balance sheet. One key issue is that terrorism losses occur at low frequency but with potentially high severity; such losses are difficult to model given the (limited) track record. It may also be very difficult to assess where might be a higher target.

22. Increasing members' retentions could also see terrorism cover subject to insurance underwriting cycles, with corresponding peaks and troughs in the cost of cover.

Q8. 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?

23. Following a terrorism event, the market appetite for additional ILS may be likely to dry up in the short term, or be very costly. ILS are also less liquid than the traditional reinsurance, so costs post-event are likely to increase more than traditional reinsurance. As a temporary arrangement however, additional ILS could be a cost-effective solution.

Q9. 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?

24. Following a terrorism event, there would be much reduced capacity and further retrocession could be very expensive. This could also persist for some years until reinsurers built-up sufficient reserves again.

Q11: 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. (Please note that questions on the scheme rules that govern Pool Re are set out in chapter 8.)

25. The existence of Pool Re may have hindered the emergence of a larger private market: without Pool Re, there would be a greater private market. However, a larger private market may not necessarily be beneficial to insured parties, as some could find it difficult to get cover/ affordable cover.

26. Prior to the COVID-19 crisis, some private insurers covered business interruption losses arising from terrorism. Not many policyholders are necessarily aware of this, and perhaps the existence of Pool Re has impacted this lack of awareness.

Q12. 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?

27. Although differentiation of treatment may allow higher retentions of some risks, there would also be the possibility of anti-selection by members. It may be useful to draw upon experience with Flood Re, which may have considered an equivalent approach and its implications in that context.

28. Price differentiation between risks by attack could be significant though, and the market has not had experience with CBRN losses, compared to conventional terrorism attacks. This could make some risks uninsurable.

Q15. 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?

29. There would likely be more differentiation in pricing – with some cover becoming much more expensive.

Q18. 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?

30. Reducing reliance on Pool Re would lead to more private participation, but there would then likely be a significant withdrawal following a major terrorism event. Experience following the attacks on the World Trade Center (2001) showed that insurers were unwilling to provide cover without government support.

31. One potential incentive would be to make catastrophe bonds, ILS or (re)insurers' ability to set up substantial pre-funded reserves more attractive from a taxation point of view.

32. It may also be helpful to increase awareness / transparency of terrorism insurance to the business sector (and wider public), in order to encourage greater take-up rates and incentivise self-protection.

Q21. 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?

33. Some SME firms may have the misconception that the UK government will step-in following terrorism attacks. Given how the UK government has stepped-in to provide financial support (including the furlough scheme) to many businesses during the COVID-19 crisis, there may a heightened expectation of the UK government to act in a similar fashion following any severe terrorism attack.

Should you want to discuss any of the points raised please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk) in the first instance.

Yours Sincerely,

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President, Institute and Faculty of Actuaries