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

Response from AXA's UK Companies

1. AXA Group is a worldwide leader in financial services, operating in 57 countries with over 160,000 employees and 108 million customers. AXA has around 11 million customers in the UK and operates through specific operating companies – AXA Insurance, AXA Health and AXA XL. AXA Insurance and AXA XL's Lloyd's and company market insurers have provided the expertise for this response.

Executive Summary

2. AXA welcomes the opportunity to respond to this Call for Evidence on Pool Reinsurance Limited. For over 25 years, Pool Re has played an important role in the growth and continuity of the terrorism insurance market and supporting businesses to get the cover they need. One of the reasons for its success has been the management of the scheme by industry experts with operational independence.

3. AXA acknowledges the Government's intention to gather views on the risk sharing between HM Treasury and the private sector and the appropriateness of the rules that govern Pool Re. As the nature of terrorism evolves, it is important that the commercial insurance and reinsurance market responds appropriately to ensure continued effectiveness going forward. Retrocession and Insurance linked securities (ILS) has been used to place greater levels of risk in the private market, but AXA appreciates there is the potential for more fundamental changes to Pool Re to enable greater levels of retention in the commercial insurance market.

4. The success of Pool Re has been largely because of its simplicity and stability, which is why it has ensured continuity of the terrorism insurance market in the UK. Pool Re since its inception has been governed by clear scheme rules which, due to its very nature, are different to those used for risk differentiation and increased risk-sharing between the public and private sector. While it is correct to continually assess the suitability of risk sharing under Pool Re, and there would be some benefits to increasing the burden of risk taken-up by the private sector, HM Treasury should be aware of the potential risks associated with a radical change of Pool Re scheme rules and structure including adverse selection, changes to Pool Re's risk portfolio and increased customer exposure to market volatility. The HM Treasury review should also consider the administrative and operational burden for insurers and reinsurers that would be attached to radical changes to Pool Re.

Response

HM Treasury's guarantee of Pool Re

Question 1

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?

5. AXA believes that the following factors should be assessed in deciding whether the HM Treasury guarantee of Pool Re remains necessary:

    - The appetite of Pool Re members to accept additional risk
    - The availability of commercial reinsurance for terrorism and whether commercial reinsurance cover includes Chemical, Biological, Radiological and Nuclear (CBRN)
    - An assessment of market cycles; there is concern commercial reinsurance is cyclical – it may be available one year and reduced/removed in subsequent years – which may require a longer-term commitment from reinsurers. There is also concern that the terrorism pricing would be hidden within the property damage and business interruption (PDBI) pricing and would then be subject to price fluctuations in line with hard/soft market cycles, rather than the consistent pricing seen today

Question 2

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.

6. AXA believes that the HMT guarantee of Pool Re is necessary to ensure the ongoing availability and affordability of terrorism (re)insurance cover, even for purely conventional terrorism risks aside from CBRN. CBRN is of course a huge challenge for the commercial insurance market, CBRN events could potentially result in non-localised damage and / or widespread business closure that would ultimately result in much higher and less predictable losses. It would be unlikely for these risk types to be replicated in the private sector, for example AXA is unaware of any existing providers offering this cover. It is AXA's view that insurers will have a net appetite for writing terrorism business where cover would be similar to current Pool Re net retention levels. For the commercial insurance market to provide cover beyond this level would depend on the factors outlined in response to question 1, in particular the consistent availability of commercial reinsurance at an acceptable price.

Question 3

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 £30bn and £100bn, and the possibility of a cap being per event or an annual limit.

7. Insurers will only provide direct cover that has back-to-back reinsurance support. If a limit was introduced, insurers would need to understand how this limit would be allocated between members in the event of a loss. Insurers could only then offer cover which would not exhaust their limit and net retention. This could lead to cover only being offered on a fixed loss limit below the actual value at risk. Such products would enable a large number of policies still to be made available, but individual customers could end up with a shortfall in the event of a loss.

8. AXA believes an aggregate limit would be even more challenging for insurers. If the aggregate limit was to be exhausted, members would effectively be restricted to their net retention. The undesired outcome would likely be the immediate withdrawal of cover for customers.

Question 4

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?

9. If the unlimited guarantee was removed, each insurer would likely appraise Pool Re's security status based on its own criteria. All insurers have strict guidelines as to the level of reinsurance that can be placed with a single reinsurer, both per placement and in-turn as an overall aggregate. If the guarantee was removed there would likely be a cap placed on the use of Pool Re and therefore, a cap on the level of direct business written which could be ceded. This would potentially lead to a reduction in capacity and availability to customers and higher prices.

Question 5

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?

10. AXA believes HM Treasury's guarantee can only be successfully reduced if the insurance and reinsurance market is willing to consistently take a larger share of the risk or insurers are prepared to accept a reduced / capped cover to customers. While there has previously been a trend for insurers to take on greater levels of terrorism risk, there could arguably be a general shift in risk appetite away from systemic risk such as terrorism following Covid-19, which would suggest that any transfer needs to be phased, progressive and should delineate between conventional terrorism risks and CBRN.

Increasing reliance on the private market

Question 6
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.

11. AXA would highlight that current Pool Re retention levels may already be at the limit of risk retention appetite for some insurers. Therefore, any further increase in members' retentions could move the private insurance market further away from an acceptable risk appetite. This should also be seen within the context of Pool Re increasing members' annual retention from £200 million in the aggregate and £100 million per event in 2014 to currently £410 million in the aggregate and £250 million per event.

12. Any short-term 'shock' increase in retention wouldn't be acceptable to AXA Insurance and could impact on availability and affordability. Continued membership in this scenario would likely depend on the availability of commercial reinsurance at quite a low level in the programme. As there is currently no such requirement, it is difficult to appraise whether the reinsurance market would consistently provide such cover at reasonable prices, but this should be considered when determining next steps.

13. Smaller incremental increases over several years may be considered more acceptable. To manage this scenario appropriately, individual insurers may need to increase margin to Pool Re base rates in order to fund the increased exposure. Pool Re would also likely need to provide a corresponding decrease in base rates or alternatively customers would be presented with higher prices.

14. An alternative solution may be a flexible treaty approach whereby members can choose their retentions (subject to an agreed minimum) with commensurate rates applying. This would enable Pool Re to transfer more risk to those members with higher risk appetite whilst those with lower appetite could continue to participate and offer consistent cover to customers.

Question 7
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?

15. The two main factors affecting AXA's ability to retain terrorism cover are:
    - AXA Group's appetite statement in relation to net retained risk, in order to manage volatility and therefore, solvency
    - The consistent availability of commercial reinsurance at reasonable terms and acceptable financial security / counter-party risk

16. AXA would urge Pool Re to share its risk modelling with members to support them in better understanding their terrorism exposures. Improved transparency may lead to broader risk appetite and better-quality disclosure of data to potential reinsurers – potentially increasing

the capacity appetite of both, depending on how Pool Re modelling compares with member modelling.

Question 8
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?

17. This is not an area where we have expertise, therefore it is inappropriate for AXA to comment.

Question 9
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?

18. AXA accepts that in theory, the exposure of HM Treasury could be reduced by additional retrocession subject to the availability of capacity at reasonable prices. As alluded to in earlier answers, it is the consistent availability of capacity that is important. Following a major terrorist event, the likelihood is that such capacity would contract leaving gaps in the market and higher prices for customers.

Question 10
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.

19. The current Pool Re system is effective because of its simplicity and a risk-share which ensures continuity of the terrorism risk insurance market in the UK. However, AXA appreciates the objectives of HM Treasury's review in assessing the suitability of the risk share between HM Treasury and the private sector.

20. Currently, large swathes of the UK are of lower terrorism exposure – the Pool Re Zone C and D postcodes. Members may potentially have greater risk appetite in these areas where the threat level is typically low and city centre aggregations are less likely. Furthermore, potential reinsurance is likely available at reasonable prices. In these areas, there may not be the same evidence of market failure seen elsewhere in high-risk / accumulation city centres. Therefore, these areas could provide an opportunity for HM Treasury to transfer greater risk to the private sector. In practice, this could see Pool Re partially withdrawing from parts of the market considered lower-risk, perhaps by only providing a higher stop-loss limit and in-fill CBRN cover. This approach would need to be supported by a comprehensive review of the granularity of the currently risk categorisation within Pool Re, for example postcode categorisation does not currently consider property type, a stadium or arena would likely be of a higher terrorism risk than a residential home in a Zone C or D area. Furthermore, there would be a need for regular reviews of this approach to ensure the categorisation accurately reflect risk and assess where there may be a need for further government intervention in the event of new terrorism trends.

21. Moreover, HM Treasury should be aware that radical changes to Pool Re's risk-share arrangements may result in non-compliance with rules that have governed Pool Re since its inception, such as the adverse selection principle and the requirement to 'Cede all business'. However, there is precedent in schemes such as Flood Re, for government intervention to be targeted at areas of high risk.

22. In addition, any changes to the current Pool Re framework will result in significant operational changes across the insurance industry, therefore, it is important that proposals are measured and conducted over a reasonable implementation period. HM Treasury should also note that increasing the risk burden on the terrorism risk insurance market will mean that more customers are exposed to market volatility.

Question 11
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.

23. Pool Re currently requires all of a customer's properties to be insured with them – to avoid adverse selection. As outlined above, there may be greater appetite from the private insurance market in areas currently considered of lower risk, therefore, the evidence of market failure seen in higher-risk areas such as city centres may not be as visible here. Risk-sharing and competition may be increased if a customer was permitted to select between Pool Re and market solutions based on price, security and cover just like any other head of cover. However, HM Treasury should be acutely aware that radical changes to scheme rules could result in unintended consequences for market stability and customer outcomes as outlined in response to question 10.

<u>The scheme rules and structure of Pool Re</u>

Question 12
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?

24. AXA's response to this question is covered in the answer to question 10.

Question 13
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.

25. As outlined in question 10, members already have an established categorisation based on risk via zonal postcode groups. However, it may be appropriate for the Government and Pool Re to review the suitability of this risk in light of other risk factors and emerging trends. For example, regional airports and sports stadiums may be placed within a low category of risk

due to their postcode even though the characteristics and use of the building may mean they are at a greater risk of a terrorism event. AXA believes it's important there is recognition by HM Treasury of the need for reviews to risk categories in order to incorporate building types and to respond to emerging terrorism trends and any resulting market failures. The nature of terrorism can be unpredictable and Pool Re may yet need to respond to changes in risk that we cannot define at this point.

Question 14

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?

26. The 'Cede all Business' requirement is incompatible with risk differentiation, but the advantage of the requirement is stability and continuity of the Pool Re model and the terrorism risk insurance market. If HM Treasury seeks to reduce involvement in terrorism risk, it may look to amend the 'Cede all Business' rule to ensure only the most severe risks are ceded to Pool Re as outlined elsewhere in this consultation document. This may have the effect of improving granularity in risk selection and pricing which may improve the coverage of terrorism risk among SMEs. However, HM Treasury should be mindful of the potential drawbacks of this approach. Removing the requirement would be in opposition to the underwriting doctrine of avoiding adverse selection and could result in significant impacts on Pool Re's diversification of risk within its portfolio.

Question 15

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?

27. AXA believes that if the 'Cede all Business' rule was significantly amended it could enable greater 'choice' to re-enter the market. It would likely result in reduced volumes for Pool Re and the reintroduction of greater market competition. However, cyclical variations would need to be accepted as part of market involvement and competition in the sector. Removing the 'Cede all Business' rule may reduce costs at times of soft market and potentially increase them at times of hard market. Furthermore, as expressed elsewhere in this consultation document risk differentiation and current scheme rules are incompatible; scheme rules were originally put in place to provide market stability and ensure cover is available to all customers that need it. By opening up the market to greater risk differentiation customers become more exposed to cyclical market volatility and risk appetite, this could have adverse impacts on the availability and affordability of terrorism insurance.

Question 16

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?

28. The 'All or Nothing' rule protects against adverse selection, therefore weakening will likely increase the level of adverse selection. It is difficult to see how increased adverse selection could be directly overcome. AXA appreciates that there would be advantages to HM Treasury by assessing where market failure appears within the terrorism insurance market and solely focus direct intervention via Pool Re in those areas. This approach would be more akin to Flood Re scheme. However, as outlined throughout the consultation document, there are potential risks in terms of stability, continuity of cover and affordability for consumers.

Question 17

Would it be beneficial for members and/or the wider terrorism (re)insurance market to allow policy holders to select in such a way?

29. AXA has outlined a number of potential benefits and drawbacks for the market and policyholders throughout the consultation. AXA would like to reiterate that any substantial changes to Pool Re rules would be an administrative and operational challenge for its members and would result in significant initial and ongoing long-term costs. Systems will need to be updated, staff trained, manuals/guides amended, insurance and reinsurance requirements put in place and clear communication provided for customers. Therefore, there is a long return period to any benefit generated.

30. AXA would expect insurers and reinsurers who currently specialise in non-Pool Re terrorism to have the most to gain in the short and medium term from substantial Pool Re changes. For most members, it will be an exercise of managing net retentions and reinsuring what is outside of risk appetite.

Question 18

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?

31. Increasing private market participation in terrorism risk is related to the challenges of affordability for customers, particularly within the SME segment of the market. AXA considers penetration in the SME segment to remain very low and therefore, there is an opportunity for all stakeholders to identify and implement ways to incentivise purchases, as discussed elsewhere in this consultation. Regulatory authorities may look to other insurance markets such as Motor or Employers' Liability and consider the potential for terrorism risk insurance to be a compulsory purchase. A move to compulsory purchase would unlikely be a reasonable short-term solution for the private market as the challenges related to affordability - particularly for SMEs - would likely remain, all other things being equal. This would likely pose a potential economic burden on businesses across the UK.

32. Furthermore, regulatory authorities would need to consider the prudential implications on the removal of an unlimited guarantee for all risk types. The application of Solvency II to Pool Re could disincentivise the growth of the private market participation in terrorism risk due to operational and cost impacts on Pool Re members. AXA would urge HM Treasury to consider this element with the Prudential Regulation Authority during the process of the review.

33. With regard to promoting economic resilience to terrorism risk, Pool Re positively works with members and policyholders on risk evaluation and mitigation through their in-house experts, a notable benefit of the Pool Re's current model. Pool Re has also undertaken a lot of work to support the defence of high hazard sites. Regulatory authorities and industry could look to utilise this expertise further by working towards best practice guidance for the terrorism risk management of different property types, to support customers across the UK.

Small business access to terrorism insurance

Question 19
What percentage of SMEs do you estimate to have cover for a terrorist attack?

34. AXA estimates that between 10 per cent and 20 per cent of SMEs have cover for a terrorist attack.

Question 20
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.

35. AXA considers the primary incentive for insurers, brokers and customers is that the protection provided is very straightforward. If there is damage (Part A cover) and it is declared a terrorist incident, then an insurer is liable to pay its insured policyholders' claims. The simple mechanisms within Pool Re prevent complicated policy interpretations and complex disputes as seen in other areas, for example Business Interruption during Covid-19.

36. The clear disincentive is that current terrorism protection can be unaffordable. While Zone A/B rates do clearly reflect the risks as modelled by Pool Re, if to an SME they are unaffordable, they will be unable to purchase the cover. Furthermore, for exposures in Property Zones C/D the standard BI rate is arguably cost prohibitive, which is a strong disincentive for SMEs to take up terrorism protection.

Question 21
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?

37. AXA considers a lack of awareness and affordability to be the two drivers preventing increased uptake of terrorism insurance by SMEs in the UK. As outlined in question 20, if rates are considered unaffordable by the SME, they will be unable to purchase the cover regardless

of whether the rates accurately reflect the terrorism risks. The issue is not one of the appropriateness of cover, this is often sufficient. The market could look to identify potential discount solutions for SMEs on Pool Re rates to incentivise additional update.

38. Furthermore, a lack of awareness is likely a contributing factor to limited uptake. Insurers, Pool Re and government could look to undertake more promotion of the importance of terrorism resilience, drawing from the success of campaigns in other areas such as Flood Re.

Question 22

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).

39. One area where government could look to enable an environment more conducive to the uptake of terrorism cover by SMEs is Insurance Premium Tax (IPT). While IPT attracts significant income for the Treasury, AXA firmly believes IPT is a disincentive for people and businesses who want to responsibly protect their health and property. Terrorism cover is already an expensive purchase for SMEs due to the nature of the risk, a 12 per cent IPT rate charged on insurance premiums is an additional disincentive for SME not to purchase cover, particularly in the current recessionary climate. HM Treasury could look to review the rate applied to terrorism insurance premiums in order to incentivise more business to responsibly protect their property from terrorism events.

Question 23

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?

40. It is always important to ensure that pricing is accurately based on risk profile in order to ensure the price of the product is fair for the customer. However, changes to this effect may or may not increase uptake as there will always be winners and losers to any potential change in rating approach.

41. AXA considers the current rating system to be relatively simple, this is a clear benefit of Pool Re that should remain central to the HM Treasury's approach. AXA would have low appetite for a significant complication of the existing process.

If you need to get in touch regarding the information in this submission, please get in touch with AXA UK Public Affairs at ukpublicaffairs@axa-uk.co.uk.