The UK Government has proposed changes to the way Pool Re is to be funded.

Initial reports indicated that the proposed changes might have a significant impact on the provision of terrorism insurance in the UK.

Pool Re has now written to its members about the proposed changes and, although they are significant, a review of the detail indicates that there may not be any notable difference for policyholders.

BACKGROUND: POOL RE

Pool Re provides property damage and business interruption terrorism reinsurance for its insurer members.

Because of the scale of potential losses from a terrorist attack the UK Government, via HM Treasury, acts as reinsurer of last resort (via what is termed a ‘retrocession agreement’ – i.e. a reinsurance of a reinsurance) in the event that Pool Re has insufficient funds, making Pool Re’s security gilt edged.

Since it was established in 1993 Pool Re has accumulated circa £5.5 billion in reserves.

Although the insurer member is free to charge its policyholders whatever premium it wishes, it is obliged to pay Pool Re for the reinsurance at tariff rates (set by Pool Re, but agreed by HM Treasury).

In practice insurers charge the policyholder the tariff rates, plus a small loading to fund the amount of risk the insurer member has to retain across its whole account.

For many years the HM Treasury has made a charge of 10% of Pool Re’s total premium income for agreeing to act as reinsurer of last resort.

NEW HM TREASURY PROPOSALS

HM Treasury is proposing increasing the 10% charge to 50%.

In addition, HM Treasury is asking for payment of an annual dividend in the event Pool Re accrues a surplus. This dividend represents 50% of any surplus, half of which will be paid to HM Treasury and half of which will be paid to insurer members (subject to various terms and conditions).

The remaining 50% will be held in reserve by Pool Re.

These proposed changes would be effective from January 1, 2015 and are subject to regulatory approval.
WHAT DOES THIS MEAN FOR POLICYHOLDERS?

Pool Re have already stated that these proposed HM Treasury changes will not result in any amendment to tariff rates, nor will the amount that the member is required to retain increase (meaning the amount insurers load the tariff rates by should not alter).

This means the premiums payable by policyholders will not increase as a result of the HM Treasury changes, as long as the members accept the changes (which we believe they will, see ‘Next Steps’ below).

There are separate discussions being held with HM Treasury that could have some impact on the way the premium is calculated (see ‘Other Potential Changes’ below) but these are not directly related to the HM Treasury changes.

If there were to be significant terrorism losses in the future, the changes would reduce the future ability of Pool Re to fund from its own reserves. This might then lead to tariff rates increasing more than they would have had the changes not been made, however the current Pool Re reserves are so significant that the risk of this happening is low. It should also be noted that if reserves fall below £1 billion Pool Re is allowed to retain 100% of its premium.

NEXT STEPS

There had been some initial concern when news of the changes first came to light as HM Treasury had stated that unless these were accepted, it would have withdrawn as insurer of last resort which would have been a huge change.

However, in a letter dated November 5, 2014 Pool Re recommended that members accept the HM Treasury proposals and authorise Pool Re to continue to negotiate with HM Treasury.

Pool Re has called an Extraordinary General Meeting for members to vote on November 21, 2014 and the general view is that members will approve the Pool Re recommendations.

If this assumption proves incorrect, or if there are any other significant changes to Pool Re arrangements, we will advise you in a follow-up bulletin.
OTHER POTENTIAL CHANGES

In addition to the proposed changes from HM Treasury, Pool Re has told its members that it has some modernisation proposals of its own.

HM Treasury has agreed to consider these separately, subject to member and regulatory agreement, in 2015.

Exact details of the modernisation proposals are not known to us, except that they include ‘the purchase of commercial retrocession cover’ and a revised basis of pricing reflecting the risk that Pool Re assume, which would be ‘financially neutral’. This presumably means keeping the overall premium that Pool Re collects the same, but altering the way the premium is calculated.

So, while not directly linked to the changes, it could be that the basis of calculating the premiums may alter in the next 12 months or so.

There is always the potential for this to happen as Pool Re can change its rates for risks incepting at any time, subject always to HM Treasury approval.

CAPTIVE INSURER MEMBERS

Some larger policyholders may own captive insurance companies that are members of Pool Re. As mentioned above, the new proposals allow for an annual dividend to be paid out to members in the event Pool Re accrues a ‘surplus’ in the preceding year. From a captive standpoint we would recommend that shareholders and boards of directors give early consideration to how such a dividend will be dealt with.

Had the proposed arrangements been in place in 2013, the insurer members’ dividend would have totalled £61 million and this would have been shared by the members in proportion to the amount of premium ceded to Pool Re. As a rough guide, the total premium ceded to Pool Re in 2013 was circa £300 million – therefore if a captive insurer’s Pool Re premium was £100,000 then the expected dividend would have been 0.033% of £61 million = circa £20,000.

If the modernisation proposals involve a material change to Pool Re’s premium rating structure then, when details of the changes are made public, appropriate discussions can be held between the captive and the insured to consider any relevant changes to existing financial forecasting and planning.

ALTERNATIVES TO POOL RE

Policyholders should note that there is an alternative option to Pool Re and the Willis International Terrorism Team will be able to offer this alternative, or review its suitability for Willis clients upon request (including for construction risks).

A further bulletin will be issued on this subject if and when necessary but if you have any questions please contact your local Willis representative.
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