BRITISH GOVERNMENT REINSURANCE AND ACTS OF TERRORISM: THE PROBLEMS OF POOL RE

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1. INTRODUCTION

The British government has agreed to become the "reinsurer of last resort"\(^1\) for losses caused by terrorism on the British mainland\(^2\) through an alliance with Pool Reinsurance Company ("Pool Re"), the mutual reinsurance company formed by the British government to provide reinsurance cover for losses due to acts of terrorism.\(^3\) As premiums have skyrocketed, however, Pool Re has been criticized and many businesses and property holders have abandoned cover altogether. This Comment analyzes the Pool Re system, considers its shortcomings, and suggests modification of the system based on existing reinsurance models.

Section 2 of this Comment analyzes the role of reinsurance in the property insurance market by employing various economic examples to explain risk spreading through reinsurance. Section 3 discusses the terrorism exclusion in Great Britain and its projected effect on reinsurance.

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2 The British mainland includes England, Scotland, and Wales. See Aline Sullivan, Bomb Claims May Top $630 Million, BUS. INS., May 3, 1993, at 1 (discussing the government's arrangement with Pool Re). Northern Ireland is covered under a separate plan discussed at infra section 6.2.

3 Reinsurance Act (Acts of Terrorism), 1993, Ch. 18, § 2(a) (Eng.). The British government has entered into an agreement with Pool Re to act as its reinsurer. See Sullivan, supra note 2, at 46.
specifically and the British economy generally. Section 4 introduces the Pool Re system, which was conceived by Great Britain in response to the terrorism exclusion. Section 5 criticizes the Pool Re system for its economic and political shortcomings. Section 6 offers possible solutions to the problems presented by the Pool Re system by analyzing other nations' responses to similar crises.

2. THE ROLE OF REINSURANCE IN THE PROPERTY INSURANCE MARKET

2.1. Basic Terminology

It is important to define the basic terminology of the reinsurance industry. The insured is the holder of the property. The direct insurer underwrites the policy purchased by the insured, which allows the insured to protect itself against unforeseen losses. The reinsurer underwrites the liability assumed by the direct insurer. The direct insurer is known as the ceding company (since it cedes part of its premium to the reinsurer) or as the reinsured when referred to in the reinsurance scheme. The reinsurance contract establishes the relationship between the reinsured and the reinsurer. Further contracts of reinsurance may be entered into by reinsurers and the companies that insure them. The latter companies are called retrocessionaires. Retrocessionaires perform the same basic economic function as reinsurers.

2.2. What is Reinsurance?

Reinsurance is defined as "the insurance by an insurer of the liability of another insurer arising under contracts of insurance which the latter has entered into." This does not

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5 See 1 GERATHEWOHL ET AL., supra note 4, at 49.

6 Butler, supra note 4, at 10 (emphasis added) (footnote omitted).
mean that the reinsurer takes an assignment of a part of the ceding companies’ original contracts with their insureds, nor does it mean that the reinsurer has in some way assumed the liability of the ceding companies. Instead, reinsurers insure direct insurers for a pre-determined part of their liability. Both the reinsurers and the reinsureds recognize that there may be times when the reinsureds must pay their insureds without any indemnification from the reinsurer—a situation in contrast to the “assumption of liability” theory. To illustrate, in Excess of Loss (“XL”) reinsurance, the reinsurer will agree to indemnify the direct insurer in case the direct insurer needs to pay a claim in excess of an agreed upon limit set forth in the reinsurance contract. The money goes to the reinsured, not the insured, and is only paid upon the occurrence of an event that results in a loss greater than the pre-determined limit.

2.3. The Purpose of Reinsurance

Reinsurance spreads the risk assumed by the direct insurer with regard to a particular event. In an ideal insurance market, direct insurers would not need to reinsure the risks that they underwrite. Instead, they would charge all of their insureds an economically efficient premium and use the capital generated by these premiums to settle claims.

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7 In this Comment, the examples and discussion will focus on excess of loss reinsurance, which is the type of reinsurance to be provided by Pool Re and the British government.

8 This limit is called “the priority, excess or retention.” Butler, supra note 4, at 12.

9 For example, if the limit is £1 million and the loss is £500,000, the direct insurer bears the whole loss. If the loss is £1.5 million, the reinsurer will have to pay the reinsured £500,000.

10 Ideally, an economically efficient premium would be calculated by an insurance company that has perfect information regarding the insureds, the probabilities of loss-causing events, and the amount of any possible loss. See 1 Gerathewohl et al., supra note 4, at 3-6. Additionally, there must be a sufficiently large number of similar risks requiring insurance in order to calculate this premium. This is the “law of large numbers.” See Elizabeth A. Kessler, Political Risk Insurance and the Overseas Private Investment Corporation: What Happened to the Private Sector?, 13 N.Y.L. Sch. J. INT’L & COMP. L. 203, 206 (1992).

11 For example, if the insurer knows that out of his 1,000 insureds one will suffer a loss of £10,000, the insurer can charge a pure premium of one
Insurance companies, however, are unable to calculate an economically efficient premium because they do not have perfect information. Insurance companies face three basic risks that contribute to this imperfect information: risks from random fluctuations, change, and error.

The risk of random fluctuations is the risk that actual claims lodged with the insurance company will deviate from anticipated claims. The risk of change results from variations in items such as the underlying value of an asset, prices, and wages. Since insurance contracts are constantly rewritten to cover such changes, this adds an element of risk to the insurer's contracts. The risk of error refers to the risk that the insurer has calculated its premiums based on false values for the probability of an event occurring. The existence of each of the above risks forces insurance companies to lessen their exposure.

One way an insurer may cut down on its risk is by reducing the consequences of the risk by charging a high safety loading on the risk premium. A safety loading is an amount collected by an insurer in excess of an economically efficient premium. This has the effect of creating a large pool of assets that can be used to offset possible claims. In a competitive market, however, charging a high safety loading on a premium may drive the insurer out of business. Alternatively, the insurer may elect to carry a large amount of uncommitted assets to protect against the underwriting risk. This alternative is not economically efficient, however, as these uncommitted assets will not find their most productive use if simply set aside. Normally, these two methods by themselves will not provide efficient cover but, if combined with reinsurance, an effective system of risk spreading can be established.

percent (or £10) to each insured and not require any additional risk spreading.

12 See 1 GERATHEWOHL ET AL., supra note 4, at 9-13.
13 See id. at 13-21.
14 See id. at 8. Discussions of this type of risk are usually subsumed in discussions of the other types of risk because the risk of error simply reflects the risks of change and random fluctuation. See id.
15 Id. at 21.
16 Id.
The best way to demonstrate how reinsurance provides efficient cover is through a highly simplified example.\footnote{This example is based, in large part, on an example from 1 GERATHEWOHL ET AL., \textit{supra} note 4, at 51.} Building $B$ has a value of £10 million. It is insured by insurance companies $X$ and $Y$, with each insuring fifty percent of the total value of the building. $X$ and $Y$ reinsure their risks with reinsurers $R_1 \ldots R_4$ and $R_5 \ldots R_8$, respectively, through reinsurance contracts while retaining forty percent of their respective risks for their own accounts. If the building is destroyed, the £10 million loss will no longer be borne entirely by $X$ and $Y$. $X$ and $Y$ will have to pay the loss up front but, ultimately, their net payout will be limited to £2 million each.\footnote{40\% \times 50\% = 20\% of the original sum insured, or £2 million.} The reinsurers will pay £750,000 each.\footnote{25\% \times 60\% \times 50\% = 7.5\% of the original sum insured, or £750,000.} The risk and the loss have been effectively spread from two insurers to ten through the use of reinsurance. This scenario can be extended by adding more direct insurers and more reinsurers.\footnote{The use of retrocessionaires adds yet another level to this example of risk spreading activity. See 1 GERATHEWOHL ET AL., \textit{supra} note 4, at 49-54. This is essentially the role that the British government will be playing in the Pool Re scheme. See \textit{Pool Re Law Enacted but Future Questioned}, BUS. INS., May 31, 1993, at 29.}

2.4. Why is Reinsurance Particularly Important in the Property Insurance Context?

Property insurance usually covers the most highly valued assets of a corporation. An increase in the value of the insured property increases the need for reinsurance. Coalitions of direct insurers can be formed to write underlying direct policies that offer cover to the property owners, but if a loss is too great, in the absence of reinsurance, insurers in the coalition could become insolvent.\footnote{It is important to note that the above example is somewhat simplified because it assumes that the reinsurers and direct insurers are different entities. Also, it ignores the problem of obligatory reinsurance treaties that may force $X$ or $Y$ to assume some of the risks that they thought they had shifted to the reinsurers. See 1 GERATHEWOHL ET AL., \textit{supra} note 4, at 49-50.} Therefore, reinsurance is

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  \item For example, if, instead of reinsuring the risk, direct insurer $X$ in the above example had elected to bear all of the risk itself, it would need £5
\end{itemize}
necessary to spread effectively the risk and possible loss where highly valuable property is concerned. Without reinsurance, direct insurers are unlikely to enter into direct insurance contracts. This, in turn, will force property owners, unable to substitute fixed costs for variable ones, to self-insure, go without cover, or sell their property. This can cause great disruption in a nation's economy, especially if the owners decide to sell and move elsewhere.

3. THE TERRORISM EXCLUSION IN GREAT BRITAIN

The Irish Republican Army ("IRA"), in an effort to force Great Britain to withdraw from Northern Ireland, has been waging a terrorist campaign against the British for many years. In 1992, the IRA stepped up its campaign of "economic disruption" by exploding many bombs throughout England. One such attack, the St. Mary's Axe bombing, which took place in the heart of London's financial district in April of 1992, caused an estimated £350 million (approximately $520 million) worth of damage. In light of these attacks, continental reinsurers, led by Munich million in reserve to prevent insolvency. Insolvency is one of the major problems facing the insurance and reinsurance industry today. See Stacy Shapiro, U.K. Reinsurers Exclude Terrorist Acts, BUS. INS., Nov. 23, 1992, at 53, 54. See generally Jan Woloniecki & John Milligan-Whyte, Off-Shore Reinsurance Disputes: Forum Shopping & Insolvency, 60 DEF. COUNS. J. 205, 210 (1993) (summarizing reinsurance insolvencies); James M. Burcke, Insurer Solvency Will Be Key Issue in 1991: Survey, BUS. INS., Dec. 31, 1990, at 12 (summarizing reinsurance insolvencies).

22 See discussion infra section 3.

23 See HENRY PATTERSON, THE POLITICS OF ILLUSION: REPUBLICANISM AND SOCIALISM IN MODERN IRELAND 3-5 (1989). Recently, the IRA has declared a unilateral cease-fire in an attempt to build goodwill for peace talks with the British government. As of the writing of this Comment, however, it is unclear whether this cease-fire will last. See William E. Schmidt, Cease-fire in Northern Ireland: The Overview—I.R.A. Declares Cease-fire, Seeing "New Opportunity" to Negotiate Irish Peace, N.Y. TIMES, Sept. 1, 1994, at A1, A12.


26 In 1992, reinsurers based in Germany and Switzerland held many of the reinsurance contracts for British property. See William Gloyn, Insurance Against Terrorism, L. SOC'Y GAZETTE, June 9, 1993, at 20, 20.
Reinsurance of Germany, announced that effective January 1, 1993, they would be excluding terrorism cover from their treaties of reinsurance. British reinsurers followed suit. In turn, direct insurers announced that they would be writing terrorism exclusions into their own commercial property insurance policies because of the unavailability of reinsurance.

The proposed terrorism exclusion created fears of an economic crisis in Great Britain. If cover for terrorism losses were not available, a number of economic consequences could

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It is important to understand the economics underlying the decision of reinsurers to pull out of the “terrorism market.” First, it is clear that large losses alone do not drive insurers out of the market; exodus from the market typically is caused by more significant events, such as a failure of the premium system. The breakdown in the system of terrorism cover likely is linked to the inability of insurers and reinsurers to adequately estimate the risk to be insured. As discussed at supra section 2.3, this is known as the risk of random fluctuation. It is difficult to do a meaningful risk assessment where terrorism is concerned as the destructive acts in question are undertaken intentionally. Hence, premium payments will not be sufficient to cover potential losses unless the insurer makes dire forecasts and charges accordingly. In that event, many potential insurance purchasers will find insurance priced extremely high and likely will not buy.

28 See Shapiro, supra note 21, at 53.

29 A few residential properties were also affected by the exclusion. See Michael Heseltine Announces Improved Terrorism Premiums for Blocks of Flats, HERMES-UK GOVERNMENT PRESS RELEASES, Mar. 4, 1993, available in LEXIS, News Library, Txtnws File.

30 See Gibson, supra note 27, at 2; see also John Wooden, The City Takes Cover-Terrorism Insurance, ACCOUNTANCY AGE, June 1, 1993, at 40 (discussing the unavailability of reinsurance and potential solutions to this problem). See generally Gavin Souter, U.K. Terrorism Coverage Plan Criticized, BUS. INS., June 28, 1993, at 13 (describing the historical developments that led to the creation of Pool Re and the administration of the system).

The terrorism exclusion in Great Britain affects both tenants and landlords. Foreign businesses that do not own property in Great Britain, except for leases in office towers (in the sense that leases are property interests), could find themselves without cover in the event of a terrorist attack. Hence, the international ramifications of the terrorism exclusion loom large for such businesses. See Steven Fogel & Sally Pinkerton, Terrorism and Leases, EST. GAZETTE, Feb. 20, 1993, at 74, 74 (emphasizing that landlords or mortgagees may end up paying the bill for damage from terrorist activities); see also Charlie Jacoby, Building a Ring of Steel, EST. GAZETTE, Nov. 27, 1993, at 99, 102 (discussing the reactions of many leaseholders in the “bomb site” areas of London’s financial district).
ensue: the slowly recovering real estate market in Great Britain could collapse;\textsuperscript{31} widespread business bankruptcies could occur in the event of another burst of terrorist activity;\textsuperscript{32} bank lending bases secured by property would be suspect as the value of the underlying property would decline;\textsuperscript{33} property developers would be unable to secure financing for their projects;\textsuperscript{34} and pension funds would be unable to rely on income from property investments, thereby reducing their liquidity.\textsuperscript{35} The public demand for government action, fueled by the doomsday predictions of the Association of British Insurers ("ABI"),\textsuperscript{36} a trade group, led to a December 1992 announcement by Michael Heseltine, the President of the Board of Trade,\textsuperscript{37} that the British government would act to ensure that cover for terrorist attacks would be available for property owners in Great Britain.\textsuperscript{38}

4. THE BRITISH SYSTEM

The system of terrorism insurance established by the British government and the ABI creates five distinct layers of terrorism cover.\textsuperscript{39} The policyholder will, as usual, deal first

\textsuperscript{31} See End of Terror Cover Sparks Crisis Fears, LLOYDS LIST, Dec. 14, 1992, available in LEXIS, World Library, Txtlne File (noting that without terrorism coverage, investors will invest elsewhere causing the real estate market to collapse).
\textsuperscript{32} Gibson, supra note 27, at 2.
\textsuperscript{33} Id.
\textsuperscript{34} Id.
\textsuperscript{35} Id.
\textsuperscript{36} The ABI pressured the British government to provide coverage for non-economic reasons, arguing that terrorism is a political problem and that the government should therefore bear the losses. See Maria Kielmas, Terrorism Losses Spark Debate Over Responsibility, BUS. INS., July 12, 1993, at 19; Helen Smith, British Insurers Demand Government Foots Bill for Terrorism, REUTER LIB. REP., Dec. 4, 1992, available in LEXIS, World Library, Reuwld File.
\textsuperscript{37} See Durman, supra note 1, at 1 (noting that the Board of Trade is a branch of the Department of Trade and Industry).
\textsuperscript{38} Id. The bill eventually passed with the support of both parties in the House of Commons. See Terrorism Reinsurance Bill Progresses, CHARTERED SURVEYOR WKLY., May 20, 1993, at 69, available in LEXIS, World Library, Txtlne File (noting that the bill was expected to be approved by both parties).
\textsuperscript{39} It is useful to consider an ideal no-exclusion policy at this point. The World Trade Center, a recent target of terrorist attack, provides an example.
with its direct insurers to obtain basic property cover. The insured will then have the option to buy additional cover to protect against terrorism losses from those same insurers. It is this additional cover which is affected by Pool Re and the guarantee of the British government.

4.1. Primary Layers

The first layer of additional protection afforded to the policyholder will be the excess on the underlying policy. This amount is unlikely to be significant as the excess would cover little, if any, loss due to a terrorist act. The second primary layer is a £100,000 cover per policy section provided directly by the insurers (without reinsurance) for damage caused by terrorism. This £100,000 limit applies to five types of damage: property damage to buildings, damage to building contents, business interruption, book debts, and damage to engineering and computers. Thus, the total maximum limit of protection at each location is £500,000. This protection was left intact after the imposition of the terrorism exclusion because the British insurers felt that they needed to provide at least some terrorism cover for small commercial entities. Any losses claimed by a policyholder...
due to a terrorist attack that do not exceed the £100,000 limit per policy section will be borne entirely by the insurer with no reimbursement from the government-guaranteed Pool Re system.45

4.2. Pool Reinsurance Ltd.

4.2.1. The General Structure of Pool Re

The third and fourth layers of protection are those provided directly through Pool Re. Pool Re is a bona fide mutual46 reinsurance company47 set up by the ABI and the British government specifically to provide terrorism reinsurance cover.48 Approximately 115 insurance company members and 120 Lloyd's syndicates49 currently are members of Pool Re.50 These members cede premiums to the pool in order to provide the assets needed to reinsure the risks posed by terrorism.51 Pool Re's daily operations are managed by a board comprised of individuals selected by the member companies.52

4.2.2. Purchasing Additional Cover Under Pool Re53

If a company wishes to purchase the additional cover afforded by Pool Re, then it must purchase the cover for all property.54 In other words, the terms of the Pool Re

45 Id. at 24.
46 A "mutual" insurance or reinsurance company is one in which the owners are the participating members of the company.
47 Pool Re is authorized by the Insurance Companies Act, 1982, ch. 50, §§ 3, 9 (Eng.).
48 See Gloyn, supra note 26, at 23.
49 Although Lloyd's of London arguably is the world's most famous insurance company, it is not actually a company at all. See Kessler, supra note 10, at 215-16. Instead, Lloyd's is an insurance market in which syndicates formed by individual members enter into contracts backed by their own resources and offer insurance cover for almost any risk. See id. at 216.
50 Gloyn, supra note 26, at 24.
51 See id.
52 Id. at 23.
53 The agreement between the British government and Pool Re prohibits Pool Re members from competing with each other for terrorism insurance and encourages the members to support each other's quotations. Id. at 24.
54 Id.
agreement prevent the insured from purchasing cover only for its high-risk property. Furthermore, unless all premiums are paid within thirty days of the beginning of the policy, the policy will be void. Although these provisions seem draconian, it is likely that they will force insureds to comply, as failure to do so might render their cover invalid and the only other alternative is to self-insure.

4.2.3. Premium Setting

The premiums to be charged are based on several factors that, while typical of most insurance arrangements, require special attention in the terrorism insurance market. The first of these factors is "the total sum insured for a particular insured." The value of all properties are aggregated to determine the value of the total sum insured, including property belonging to subsidiary companies. These values are then separated into bands, with the premium rate decreasing as the insured value progresses to higher bands. Therefore, it is usually in the best interest of the insured to aggregate property.

The second factor considered in determining the premium amount is the location of the property at risk. The British mainland is divided into two zones, each having a different

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55 Id.
56 Id.
57 Id.
58 Id. at 25. The British government imposed these conditions when it created Pool Re since Pool Re had no competitors. See id.
59 The premium structure for Pool Re does not allow commissions for brokers. See Souter, supra note 30, at 13.
60 Gloyn, supra note 26, at 24.
61 Id. The amount does not, however, include those values which are protected by the £100,000 cover per policy section provided directly by the insurers. Id.
62 Id. at 25. At the inception of the program, there were five bands. During the early stages of the program, this number increased to 47. See id.
63 It should also be noted that an averaging clause is included in the Pool Re system, which penalizes underinsurance by reducing a claim settlement by an amount proportional to the underinsured amount. Id. at 24-25.
64 Id. at 25.
premium rate. Zone 1, which has the higher rate, includes London and the commercial districts of all major cities. Zone 2 encompasses all other areas of Great Britain. At the inception of the program, Zone 1 rates were roughly three to five times those of Zone 2, depending on the amount insured.

The third premium factor, unique to terrorism insurance, is the target risk. Evaluating target risk requires that rate setting personnel determine whether and to what extent a particular property is at risk of terrorist attack. If a property is determined to be a high risk target and is located in Zone 1, the premium is increased by "a 50% loading on the basic rate." If a high risk property is located in Zone 2, then the premium is increased to the base rate charged for property located in Zone 1.

Another factor in the premium structure is the British government's attachment of a levy on all household and motor vehicle policies written in Great Britain. The effect of this "IRA levy" is to shift the costs of insurance from London to other areas of the country. The three percent levy on all policies "add[s] about £18 a year ... to average household insurance bills." Obviously, high-risk area and target policyholders in London are favored by such a change.

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65 Souter, supra note 30, at 13.
66 Gloyn, supra note 26, at 25. The major cities are Birmingham, Manchester, Glasgow, Leeds, Bristol, Liverpool, Edinburgh, and Cardiff. Id.
67 Souter, supra note 30, at 13.
68 Gloyn, supra note 26, at 25.
69 Id.
70 Id.
71 Id.

This levy should be distinguished from the plan advocated by some groups that a levy be used to create a fund for insuring terrorism losses. See Sullivan, supra note 2, at 46-47 (discussing a proposal to impose a levy on all commercial and personal property policies to help fund Pool Re). The latter system, which somewhat resembles the one used in Sri Lanka, is discussed at infra section 6.3.
73 Prynn, supra note 72, at 2.
Policyholders who want nothing to do with the Pool Re system, however, object to financing insurance cover for London’s business district.

4.2.4. The Fourth Layer of Protection

If the premiums paid to Pool Re do not cover the losses caused by a terrorist attack, then an additional ten percent “call” is levied on the member insurers in the pool. This call will be instituted only if the pool is unable to absorb the claims with the funds already collected through premium payments. All member insurers are liable for the call. Essentially, this call provides that losses must exceed 110% of the total funds in the pool before the British government is required to pay directly.

4.2.5. The British Government as Retrocessionaire

If Pool Re (with the ten percent call) is exhausted because of a terrorist attack, the British government ultimately is liable for all losses in excess of that amount. In other words, the British government acts as the reinsurer of Pool Re—the reinsurer of its own members—and, therefore, as a retrocessionaire. The Secretary of State, if he acts with the consent of the Treasury, is authorized by statute to provide this type of reinsurance. Furthermore, the same statute authorizes Parliament to spend the amounts necessary to ensure that there are sufficient funds to make whole the insurance companies affected by huge terrorism losses.

The British government’s involvement in the reinsurance scheme increases risk reduction in one important way. The ability of the British government to pay for its involvement by

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74 See Gloyn, supra note 26, at 24. The call is an additional 10% above the premium already paid into Pool Re by participating companies. Id.
75 Id.
76 Reinsurance Act (Acts of Terrorism), 1993, ch. 18, § 1(1) (Eng.).
77 The statute authorizes reinsurance contracts that cover Great Britain outside of Northern Ireland. Id. § 3(2). Additionally, “only contracts covering terrorism reinsurance qualify.” Id. § 2(1). Terrorism is defined in the statute as “acts of persons acting on behalf of or in connection with any organisation which carries out activities directed towards the overthrowing or influencing, by force or violence, of Her Majesty’s government in the United Kingdom or any other government de jure or de facto.” Id. § 2(2).
levying taxes effectively spreads the cost of reinsurance throughout the British economy. Without government support, losses would be absorbed entirely by certain sectors of the British economy, creating the possibility that private insurers would become insolvent.

4.3. How the System Operates: An Example

On April 24, 1993, the IRA detonated an explosive device at Bishopsgate in London, which caused approximately £500 million to £600 million ($748 million to $896 million) in damage. For purposes of this example, assume that Pool Re had collected £250 million in premiums before this blast. Assume also that one business, Conglomerate Ltd., which is fully insured against terrorism losses through the Pool Re system, sustained £500 million in losses from the attack. As an immediate charge, the direct insurer (assuming, unrealistically, that there is only one) would have to pay the £100,000 per policy section to Conglomerate. After that, the insurer could obtain funds from Pool Re to meet excess claims. In this case, those claims would amount to £499.5 million. After the £250 million of Pool Re is exhausted, the pool will institute the additional ten percent call, which will total £224.5 million. The government will then pay the additional £224.5 million needed to cover the total loss.

5. THE SHORTCOMINGS OF THE POOL RE SYSTEM

5.1. Inadequate Risk Spreading

One of the fundamental complaints about Pool Re is that the risk of loss due to terrorist attack is not adequately

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79 No one knows exactly how much has been collected by Pool Re and how much the British government may have to pay to satisfy claims related to this terrorist attack. See id. The latest estimates of a possible government contribution have been described as marginal. See id. If the government pays anything, however, then the loss from the attack will have depleted all of Pool Re's reserves plus 10%, leaving Pool Re empty if another large terrorist attack occurred in the near future.

80 The maximum allowable amount of excess cover under Pool Re is £500,000. See discussion supra section 4.1.
dispersed throughout the economy. Inadequate risk spreading is in part a structural problem and in part a conceptual one.

The structural problem results from the way the pool is designed. Most of the companies involved in Pool Re are British. This means that any losses caused by terrorism are borne entirely by the British economy. Unlike other disasters, the costs of which are dispersed throughout the world economy with a lessened impact upon any one country, the British government pays most of the bill for terrorism losses itself. The addition of the British government as retrocessionaire does nothing to alleviate this problem on an economy-wide basis.

The conceptual problem can be illustrated by reference to the example discussed at supra section 2.3. That example is merely a model of ideal risk spreading and, therefore, deviations from the model are deviations from that ideal. The Pool Re system deviates from the ideal by requiring insurers (X and Y in the example) to act as reinsurers (R₁ and R₂), thereby cutting down on the risk spreading. In other words, the insurance companies that bear the loss directly are not helped as much by reinsurance since they themselves are contributors to the Pool Re system. An important additional criticism is that the main commercial property insurance underwriters are disproportionately represented in Pool Re. In the event of a large terrorist attack, these companies likely

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81 See Sasha Summerson, Fresh Set of Changes Planned for Pool Re, LLOYDS LIST, Aug. 3, 1993, available in LEXIS, World Library, Txtlne File. ("[Pool Re] reflect[s] . . . a fundamental departure from basic insurance principles, such as the sharing of risk across the broadest population.").

82 Clare Sambrook, Terrorism Insurer "Too Expensive," DAILY TELEGRAPH, Nov. 4, 1993, available in LEXIS, World Library, Txtlne File. Insureds in Great Britain have recognized this shortcoming of the pool.

83 Gerathewohl offers the example of insurance losses sustained upon the sinking of the passenger liner, Andrea Doria, in 1956 as a model for how risk can be spread over different markets. Gerathewohl found that, although the $16 million policy was underwritten by a coalition of 16 Italian insurers, the use of foreign reinsurers and retrocessionaires ensured that the small Italian market would only have to bear 10% of the total loss. 1 GERATHEWOHL ET AL., supra note 4, at 49.

84 In that example, X and Y would now be liable for £2.75 million, or 27.5% of the original risk insured.

85 Because the terrorism exclusion applies to most commercial properties, this result is to be expected. See Sullivan, supra note 2, at 46.
will suffer losses simultaneously, thereby further reducing risk spreading.

The amount of risk spreading is further diminished by the fact that eighty percent of the risk is concentrated in a small area of the City of London.86 This area is insured by the same group that funds Pool Re. If a bomb explodes in that area, the loss will not be spread throughout the country, but will be borne primarily by the insurers in the City of London.87 Hence, risk distribution is defeated.

Captive insurance companies may also contribute to inadequate risk spreading. A captive insurance company is one that is controlled by the insured and is usually created to cut down on premium costs.88 As the role of captives in Pool Re is unclear,89 however, they will not be discussed in detail in this Comment.

5.2. Problems with Government Involvement

5.2.1. Disincentives to Private Companies

When the British government stepped in to become the "reinsurer of last resort,"90 it effectively shut out any companies—either in England or abroad—that might have considered underwriting terrorism reinsurance. There is little incentive for private companies to compete against the British government in this scheme because of the possible size of the claims to be paid.91 The threat that insurance companies may become insolvent and thus be unable to satisfy claims, coupled with knowledge that the government always will be able to satisfy claims, might be sufficient to induce some insureds to go with Pool Re even if other private companies offered terrorism cover. It is important to note also that all of

86 Carolyn Aldred, Exclusions for Terrorism Grow, BUS. INS., Nov. 1, 1993, at 83.
87 See id. (questioning the equity of the businesses in that small area bearing 80% of the premium).
88 See 1 GERATHEWOHL ET AL., supra note 4, at 6 & n.17.
90 See Gloyn, supra note 26, at 20.
91 See id. at 23 (noting that other reinsurers will be deterred by the possibility of having to pay potentially large claims).
the premiums that are collected by the government are forever lost to the insurance industry.\textsuperscript{22}

5.2.2. Government Interference Thwarts Self-Sufficiency

The British government's involvement in the reinsurance scheme ensures that Pool Re never will become entirely self-sufficient. Members of the mutual do not have any incentive to increase premiums on their own to cover the potential losses suffered by Pool Re. Furthermore, other direct insurers who know that the British government ultimately will pay for the insurance through Pool Re will be less likely to offer non-reinsured, direct terrorism cover beyond the current £100,000 per policy section limit.\textsuperscript{93} The failure to raise these limits means that Pool Re not only will have to cover the costs of significant terrorist attacks, such as Bishopsgate and St. Mary's Axe, but also smaller ones that otherwise could be absorbed by the insurers themselves.\textsuperscript{94}

5.2.3. Administrative Burdens

There are difficulties in administering any reinsurance scheme in which the government is involved. One problem is that Great Britain generally has been slow in making required payments under other government-subsidized insurance programs.\textsuperscript{85} Another problem is that Pool Re rates are fixed through negotiations between the British government and the

\textsuperscript{22} See Missed Opportunities, WORLD INS. REP., Apr. 9, 1993, available in LEXIS, Insure Library, Wldins File (emphasizing that dissatisfaction with the Pool Re insurance scheme would cause more companies to self-insure and noting further that those entities' premiums would forever be lost to the insurance industry).

\textsuperscript{93} See supra note 43 and accompanying text.

\textsuperscript{94} For example, on a loss of £600,000, £500,000 will be borne by the insurer directly while £100,000 will be borne by Pool Re. Given the fact that any number of small, easily concealed explosive and incendiary devices can cause this amount of damage, Pool Re likely would have to pay for many attacks.

\textsuperscript{85} Under the Northern Ireland program, discussed at infra section 6.2, the British government has litigated some claims and has delayed payment of others. See Munton Bros. Ltd. v. Secretary of State, 1983 N. Ir. 369 (C.A. 1983) (noting that the British government had not yet paid for damage caused to buildings by terrorist bombs in 1971 and 1972).
insurers. These negotiations can be an arduous process involving several layers of bureaucracy.

5.2.4. The Slippery Slope to Complete Government Domination

Many in the private insurance community object to government involvement in the insurance business. These critics see government partnership with Pool Re as the first step in an eventual government takeover of the industry. Presumably, insurers would underwrite the risks themselves if there were no government involvement. This argument can be deflected, however, by noting that insurers had such an opportunity and failed to take advantage of it.

5.2.5. Pool Re Charges Excessive Rates

One improvement that could result from government involvement in Pool Re is lower premium rates. The most vocal critics of the Pool Re system, however, cite the currently high price of additional terrorism cover as one of the primary flaws of the system. Mr. Alan Fleming, executive director of the Association of Insurance and Risk Managers in Industry and Commerce, has been a vociferous critic of what his group perceives as exorbitant rates that are impervious to change.

The rating system described at supra section 4.2.3 creates particularly high rates for property located in cities on the British mainland. There is little flexibility built into the rating bands or into the area zone scheme for different size property. Furthermore, proposed rate increases do little to

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See Aldred, supra note 86, at 83; Kielmas, supra note 36, at 19.

See Kielmas, supra note 36, at 19.

The members of AIRMIC are corporate executives who are in charge of insurance and risk management for their respective companies.

See Sambrook, supra note 82; Souter, supra note 30, at 13; Pauline Springett, Risk Managers Blast Terror Indemnity Charges, THE GUARDIAN, Nov. 4, 1993, at 14; see also Kielmas, supra note 36, at 19 ("[T]he cost of terrorism must be absorbed by the economy.").

Having the British government involved, particularly if it is willing to share intelligence estimates with the raters, is helpful in determining target risks and is likely to lead to a more accurate risk assessment than would otherwise be generated by the private sector.
alleviate the fears of some risk managers that terrorism cover is basically unaffordable. This, in turn, has led some property owners to self-insure or simply to do without terrorism cover. The implications for the British economy of uninsured terrorism risks are potentially devastating.

Another complaint about the rating system is that it does not provide incentives for companies to take measures to protect themselves from being targets of terrorist attacks. Incentives such as premium deductions routinely have been used by insurance companies to deal with the problem of moral hazard. Instead of offering rewards, Pool Re mechanically applies an area- or target-specific rate without regard to the preventative measures being taken by the individual insureds.

5.3. The Troubling Definition of Terrorism

5.3.1. Was the Loss Caused by Terrorism?

The exclusion clause announced by the ABI covers damage resulting from a fire or explosion that is caused by terrorism. Terrorism is defined as "any act of any person acting on behalf of or in connection with any organisation with

101 See Sambrook, supra note 82.
102 See Vincent, supra note 40, at 13.
103 See discussion supra section 3.
104 There is a large body of literature documenting the steps businesses can take and currently are taking to protect themselves. See, e.g., Jimmy Burns & Richard Waters, The City Bombing: Search for Greater Security Gets Underway, FIN. TIMES, Apr. 27, 1993, at 11; Duncan Campbell, Big Brother Is Here, THE GUARDIAN, May 13, 1993, at 2; Alan Elias, Property and Construction Insurance: Important Lessons to Learn from Recent Losses, CHARTERED SURVEYOR WKLY., Apr. 1, 1993, available in LEXIS, World Library, Texnws File; Stacy Shapiro, U.K. Terrorism Risks: Soldier Offers Protective Tips for Businesses, BUS. INS., Apr. 12, 1993, available in LEXIS, Busfin Library, Busins File; see also Mark Hofmann, N.Y. Explosion Is a Costly Lesson in Loss Control, BUS. INS., Mar. 8, 1993, at 68 (suggesting several security measures that should be implemented at the World Trade Center).
105 Moral hazard occurs when an insured party, knowing that it has coverage, takes more risk than it would if it were not insured. See BLACK'S LAW DICTIONARY 719 (6th ed. 1990).
106 This suggests that damage caused by other acts, such as flooding a building, smashing computers, or shredding documents would still be covered under the original property policies. See Gloyn, supra note 26, at 20.
activities directed towards the overthrowing or influencing of any government . . . by force or violence." This definition, while clearly including such movements as the IRA or Sikh separatists, does not clearly include other so-called "fringe" groups. For instance, there is concern within Great Britain about the increasing radicalization of environmental and animal rights activists. It is an open question whether activities undertaken by such groups would be labelled "terrorist" for the purposes of the exclusion.

5.3.2. Who Decides Whether Terrorism Caused the Damage?

In deciding whether an act is indeed "terrorism," the usual protocol of an insurance adjuster determining the cause of the damage would probably not satisfy the British government. Since the government bears the residual risk of large terrorist attacks, it clearly would like to categorize attacks of questionable origin as something other than terrorist attacks. Additionally, there is a political stigma suffered by the government when an attack is labelled "terrorist." Furthermore, because the British government and the members of Pool Re probably will not always agree on the definition of a particular act, the Pool Re system will create costly and time-consuming litigation over the precise definition of "terrorism." Currently, the British government and the members of Pool Re are negotiating the creation of a system whereby the police will issue a certificate stating that the damage in question was caused by terrorism, but to date no agreement on a certification process has been reached.

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107 Id. at 23.
109 See Gloyn, supra note 26, at 23.
6. Possible Solutions

6.1. Modifying Pool Re

If inaccuracies with risk prediction prevent the private market for terrorism reinsurance from returning to Great Britain, Pool Re nevertheless may succeed, provided that crucial changes to the system are adopted. These changes should focus primarily on the rating structure adopted by the British government.

First, the British government should use its intelligence capabilities to refine its premium charges. One of the benefits of government involvement is that the government has better access to risk information and, hence, should be able to establish an economically efficient premium. By applying its intelligence information to the rating structure, the government can determine more easily than private companies the location and target risk of terrorist attack for particular properties.

Next, the Pool Re system should include a method of rewarding policyholders who take measures to lessen their exposure to terrorist attacks. If, for instance, an insured is willing to install security cameras, restrict building access, hire extra security guards, or purchase a trained, bomb-searching dog, then Pool Re should reduce the insured’s premium rates. Where an insured makes a bona fide

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110 The government and the ABI set up a working group to propose changes to the system to be enacted in January 1994, but the working group has failed to produce any suggestions to date. Furthermore, no one knows exactly what the working group’s mission is or who its members are. See Terrorism Insurance Proposals Awaited, EST. GAZETTE, Dec. 4, 1993, available in LEXIS, UKJnl Library, EG File (this source, formerly available through LEXIS, is no longer accessible on-line due to licensing problems; a printed copy of the article is on file with the author).

111 Regardless of how Pool Re is modified, the problem of inadequate risk spreading will remain in the system. See discussion supra section 5.1.

112 The OPIC scheme, discussed at infra section 6.4, utilizes a similar strategy. See Kessler, supra note 10, at 207.

113 These incentives, and others, have been suggested. See Charlie Jacoby, Insurance: A Risky Business, EST. GAZETTE, Nov. 27, 1993, at 101, 101 (discussing the possibility of accounting for the “blast resilience” of a building in setting the premium); Summerson, supra note 81; see also Charlie Jacoby, Security: Battening Down the Hatches, EST. GAZETTE, Nov. 27, 1993, at 56 (discussing several emergency plans for a bombing).
effort to lessen the risk of a terrorist attack on its premises, this effort should translate into lower premiums.

Additionally, the British government should abandon its "all or nothing" scheme and allow insureds to select their desired type of cover. This would ensure that companies are covered in some manner, instead of electing to self-insure. 114

Finally, increases in premiums necessitated by heightened risk or catastrophic losses should be spread out over time rather than exacted immediately from policyholders. Increasing premiums by 300% in central London 115 is economically possible, but to do so without adequate notice makes expenditure planning by insureds nearly impossible. Coupled with the thirty day premium payment limit, the economic burden on insured parties is so great that it may discourage them from insuring their property at all. 116 If the British government were to subsidize insureds either directly, through gradually increasing premium rates, or indirectly, by allowing for a later payment deadline, then insureds would be better able to absorb higher premiums.

Other changes that have been suggested for Pool Re do not address the premium system. One such change involves the methods by which Pool Re is marketed and the profit-making abilities of reinsurance brokers. Currently, brokers who sell the underlying insurance reinsured by Pool Re do not have any incentive to promote the high-premium terrorism cover. 117 Unless these brokers are allowed to collect commissions for their work, Pool Re will never function as a self-sufficient reinsurer.

Furthermore, the members of Pool Re and the British government should establish a working definition of terrorism that can be applied consistently throughout Great Britain. 118 A system also should be developed to identify quickly whether

114 See Summerson, supra note 81.
116 See Tuohy, supra note 72 (discussing the 30-day deadline to purchase additional terrorism cover and the levy applied to all policies to spread the costs of insurance throughout Great Britain); see also discussion supra section 4.2.3.
118 See id. (arguing that the scope of the terrorism exclusion is unclear).
terrorist activity caused the loss in question so that payment on related claims can begin immediately.

6.2. The Northern Ireland Model

For the past twenty years, major insurers have included a terrorism exclusion in their policies written for properties in Northern Ireland, primarily because of the turmoil and violence endemic to that area. The British government responded to the terrorism exclusion with two pieces of legislation, the Criminal Injuries to Property (Compensation) Act of 1971 and the Criminal Damage (Compensation) Order of 1977.

These acts effectively created a system whereby the British government directly compensates property owners in Northern Ireland who are injured by terrorist acts. This scheme of "government insurance" does not require that the claimant pay any premium. In order to obtain compensation, the property holder who has suffered damage must first obtain a certificate from the police stating that the damage actually resulted from a terrorist attack. Once this certificate has been obtained, the injured property holder may assert a claim against the British government for compensation. This program spreads the risk of a terrorist attack throughout all of Great Britain because tax revenues fund the program. Some commentators have suggested that a similar program of government compensation be established for terrorism losses occurring on the British mainland.

There are shortcomings to using the Northern Ireland approach to cover terrorism losses on the British mainland, however. Terrorism losses on the British mainland greatly exceed the total amount paid to date under the Northern Ireland program. Thus, the cost of implementing a

121 See Gloyn, supra note 26, at 23.
122 See id.
124 Compare id. (estimating that the cost for two British mainland bombings alone will exceed £1 billion) with Kielmas, supra note 36, at 19
similar program in the British mainland would be extremely high. This would be true even if the tax base of all of Great Britain were available to supply funds for the program.

The possibility of fraudulent claims poses another problem for implementing this type of approach on the British mainland. In Northern Ireland, individuals attempt to defraud the system by claiming losses for damage caused by non-terrorist acts, or by deliberately damaging property and attributing the damage to terrorists in order to file a claim and receive a monetary settlement from the British government. There may be less potential for fraud on the British mainland, however. First, the groups that battle in Northern Ireland co-exist more peacefully on the British mainland. Second, much less sympathy exists for terrorists on the British mainland, so they would have more difficult arranging fraudulent claims there.

The final problem with imposing the Northern Ireland system on the British mainland is political. The British government is wary of appearing unable to protect the mainland from terrorist attack. The British government understandably is reluctant to implement a program that may have the tacit effect of acknowledging the IRA's strength.

6.3. The Sri Lankan Model

Great Britain is not the only country dealing with the problem of insuring losses caused by terrorist activity. In Sri Lanka, the government created a fund known as the strike, riot, and civil commotion fund (“SRCC”) to cover losses caused by these events. Premiums are paid directly into this fund by five participating insurers. These insurers establish accounts within the fund to satisfy claims and the Sri Lankan

(noting that, between 1968 and 1993, terrorism losses in Northern Ireland totaled £695 million).

126 See Insuring Against Terror, supra note 24, at 19.

127 See Kielmas, supra note 36, at 19.

government supplements the fund as necessary.\textsuperscript{129} This fund has been extended to cover losses caused by acts of terrorism.\textsuperscript{130} While the original SRCC provides for no limit on the amount of settlements, claims resulting from terrorist acts are limited to 1.5 million rupees (approximately $37.46 million) per property, with the insurance companies being forced to pay the first 1.5 million rupees out of their own accounts when faced with losses on multiple properties.\textsuperscript{131}

Sri Lanka's program is a potential model for the British system because of a lack of foreign participation in both schemes. The British government's imposition of a cap on losses could be a productive addition to Pool Re. Some private reinsurers may be willing to return to the market to write XL policies for extremely large losses if the government provides a high enough threshold.\textsuperscript{132} This could be the kind of private interest necessary to spark the return of major reinsurers to the marketplace. Also, there would be some incidental risk-spreading benefits if insurers would cover the larger losses that exceed the government's threshold.

\textsuperscript{129} See id.

\textsuperscript{130} Id. Tamil separatists, an ethnic minority in Sri Lanka, have, in the past several years, engaged in various acts of insurgency against the government.

\textsuperscript{131} As an example, if the total loss caused by a terrorist attack was 10 million rupees and four insureds were involved (all having policies worth two million each with the same insurer), the payout would be:

1) \$0.375 million paid by the insurer to each insured from the lower premium fund account;

2) \$1.125 million paid by the government to each insured;

3) \$0.5 million paid by the insurer to each insured through a high premium private insurance arrangement.


\textsuperscript{132} See \textit{Sri Lanka: Cover for Terrorism and Subversion}, supra note 128 (explaining that the Sri Lankan system is supported by private reinsurers).
6.4. The Overseas Private Investment Corporation ("OPIC") Model

OPIC was formed by the U.S. government in order to underwrite political risk insurance in friendly, less developed countries. The risks covered by OPIC include expropriation and political violence. Political risk insurance is similar to terrorism cover in that terrorism is somewhat subsumed by political risk insurance and because there is a very narrow market for political risk insurance. OPIC has experienced little competition from the private sector and has proved profitable for the U.S. government.

OPIC functions as a traditional insurance company and utilizes ordinary principles in determining premiums. It uses these premiums to create reserves that are used to pay claims. In order to ensure that it will be able to satisfy all claims, OPIC limits the amount of cover that any one insured can purchase to no greater than ten percent of OPIC's total liability exposure. This ensures that the total reserve depletion by an insured's claim for any one event will not exceed ten percent.

OPIC provides a strong model for the British reinsurance scheme. OPIC resembles the Sri Lanka system, though OPIC does eliminate private insurers. If the British government accepts the inadequate risk-spreading of the current Pool Re structure, it should consider instituting a government-backed direct insurer. Establishing such an entity would enable the British government to set levy-subsidized premium rates and force all commercial property owners to insure against terrorism.

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133 OPIC was created as an independent government agency acting as a corporation. See 22 U.S.C. §§ 2191-2200 (1988).
134 See Kessler, supra note 10, at 204 & n.4.
135 See id. at 205. Clearly, the scope of OPIC's mandate extends far beyond simply acting as an insurer. See 22 U.S.C. § 2191-2200 (1988). For example, it is a State Department vehicle for indirect foreign subsidies, as well as foreign aid. See Kessler, supra note 10, at 204-05. This Comment, however, is concerned only with the functioning of OPIC's insurance system.
136 See Kessler, supra note 10, at 204 n.4.
137 See id.
138 See id. at 205-06.
139 Id. at 208.
140 Private insurers are not interested in the British system because of terrorism.
terrorist attack. A ten percent limit similar to that in the OPIC system could be utilized with the limit applied to specified small geographic areas in the country.\textsuperscript{141} Although the British government ultimately would be responsible for settling claims, the administrative costs of running Pool Re would be eliminated and cover would be guaranteed by the British government. The problem of defining terrorism would be eliminated and, if the system were profitable, concerns about the lack of a private market would diminish.\textsuperscript{142}

7. CONCLUSION

Currently, affected parties are demanding that the British government help provide insurance cover for terrorism losses. The unavailability of terrorism cover, due to the exit of the German and Swiss reinsurers from the marketplace, has potentially devastating effects for the British and world economies.\textsuperscript{143} Therefore, there is a pressing need for the British government to offer an economically feasible reinsurance program.

The British government's decision to act as the reinsurer of last resort through the Pool Re system, however, may not be the most efficient and effective solution to the reinsurance problem. Problems of inadequate risk spreading, government inefficiency, and excessive premiums threaten both the long- and short-term viability of the program.

Improvements to the Pool Re system through more realistic premium setting and better brokerage rules would assist Pool Re in becoming more independent and economically efficient. The British government and its ABI partners appear to favor this strategy. If these types of changes are not affected, however, modeling a reinsurance scheme after OPIC may provide the best way to guarantee that terrorism cover is available in Great Britain.

Regardless of which type of strategy the British government adopts, it is evident that the country will continue

\textsuperscript{141} For instance, different shires or blocks in London would constitute these separate units.

\textsuperscript{142} See \textit{supra} note 91 and accompanying text. Some commentators fear that this could be used as a future justification for government nationalization of the industry. See Kielmas, \textit{supra} note 36, at 19.

\textsuperscript{143} See discussion \textit{supra} section 3.
to be a target for terrorist activity. Therefore, it is essential that the British government, insurers, and insureds maintain their vigilance in order to protect themselves and their properties from losses associated with terrorist attacks.