

Competition Act 1998

Decision of the Office of Fair Trading

No. CA98/03/2004

Pool Reinsurance Company Limited

15 April 2004

(Case CE/ 2611/ 03)

SUMMARY

The Office of Fair Trading (OFT) has concluded that some of the rules of Pool Reinsurance Company Limited (Pool Re) appreciably prevent, restrict or distort competition but that the requirements for individual exemption are met.

Pool Re was set up in mid-1993 to provide reinsurance against acts of terrorism in the United Kingdom, excluding Northern Ireland and the territorial waters. It acts as a reinsurer for liabilities arising from acts of terrorism for direct insurers providing commercial property insurance.

Pool Re has sought a decision from the OFT as to whether or not the various agreements and documents establishing Pool Re and governing its relations with its members (the notified arrangements) are caught by the Chapter I or Chapter II prohibitions of the Competition Act 1998. Pool Re has also requested that, if the notified arrangements are caught by the Chapter I prohibition, the OFT should grant them an individual exemption.

The OFT has concluded that three of the rules which form part of the notified arrangements are caught by the Chapter I prohibition since they have the effect of appreciably preventing, restricting or distorting competition. The first of these rules requires Pool Re members to offer Terrorism Cover only in conjunction with General Cover. The second rule requires Pool Re members to reinsure all their terrorism insurance business with Pool Re. The third rule requires that all policyholders (the insureds) wishing to buy insurance of Terrorism Cover for one or more of their commercial properties from a Pool Re member must buy such cover for their entire

portfolio of commercial properties from Pool Re members. However, the OFT has concluded that, in each case, the requirements for individual exemption from the Chapter I prohibition are met. The OFT has not addressed the question of whether the notified arrangements give rise to an infringement of the Chapter II prohibition.

A notice setting out the OFT's proposal to grant an unconditional individual exemption was issued on 11 February 2003 and responses to this notice were invited. A number of responses were received as a result of this public consultation. None of these responses were such as to materially alter the OFT's proposed decision.

I THE FACTS

A Background

- 1 As a result of the IRA bombing in St Mary Axe in the City of London in 1992, reinsurers withdrew their cover of insured terrorist risks for commercial property in mainland Great Britain. Consequently, insurers decided to offer customers general insurance for commercial property (hereafter referred to as 'general cover'¹) on terms which excluded cover for losses from fire and explosion caused by any event which constitutes an act of terrorism. As a result, insurance against damage to commercial property caused by an act of terrorism became unavailable.
- 2 Following consultation with industry trade associations which raised concerns about the situation, the Reinsurance (Acts of Terrorism) Act 1993 was enacted. Pool Re was set up as a company limited by guarantee, to act as a reinsurer in respect of Terrorism Cover,² for all insurers wishing to become a member and which insure commercial property in the United Kingdom, excluding Northern Ireland and the territorial waters (the territorial scope of the notified arrangements is hereafter referred to as 'GB'). HM Government agreed, pursuant to its powers under the Reinsurance (Acts of Terrorism) Act 1993, to act as reinsurer of last resort by reinsuring Pool Re in respect of its liabilities to direct insurers. The Pool Re scheme requires insurers, when Terrorism Cover is requested, to offer Terrorism Cover within general cover for commercial property; general cover, which excludes cover in respect of an act of terrorism, is referred to as 'General Cover'. Claims under the scheme may relate to actual property damage and to consequential losses such as those arising from the interruption of business.
- 3 On 7 March 2003, the OFT received a request from Pool Re for a decision under the Competition Act 1998 (the Act) in relation to various Pool Re agreements which were entered into, in their original form, in 1993 and some of which were

¹ In this document the term 'general cover' refers to direct insurance cover for commercial property in Great Britain for the risk of fire and/or explosion for any of the following heads of cover: (i) buildings and completed structures, (ii) other commercial property (including contents, engineering, contractors and computers), (iii) business interruption, (iv) book debts.

² 'Terrorism Cover', as defined under the notified arrangements, means insurance to cover all losses, arising under any of the heads of cover referred to in footnote 1, as a result of damage to or the destruction of property in Great Britain, the proximate cause of which is an act of terrorism. This includes cover for all risks resulting from acts of terrorism (excluding damage caused by computer hacking, viruses, denial of service attack and war risks). This definition differs slightly from the definition of Terrorism Cover under the original arrangements setting up Pool Re.

amended with effect from 31 December 2002. Pool Re requested (i) a decision that the notified arrangements are not caught by the Chapter I prohibition imposed by section 2 of the Act or, in the alternative, an individual exemption decision under section 4 of the Act, and (ii) a decision that the notified arrangements do not infringe the Chapter II prohibition imposed by section 18 of the Act.

- 4 A summary of the nature and objectives of the notified arrangements was placed on the OFT's public register on 5 June 2003.³ The OFT requested information from a number of Pool Re members, competitors and insureds concerning the impact of the Pool Re arrangements on competition.
- 5 Following consideration by the OFT of the notification and the responses to the information requests, a notice was issued under the Act in accordance with rule 12(1)(a) of the Director's procedural rules⁴ (the Director's rules). This provides that if, on an application under section 14 of the Act for an agreement to be examined, the OFT proposes to grant an individual exemption, whether or not subject to conditions or obligations, it must consult the public. The notice set out the OFT's proposal to grant an individual exemption from the Chapter I prohibition to the notified arrangements, its reasons and the period within which written representations could be made to the OFT on these matters. A number of responses were received as a result of the public consultation. None of these responses were such as to materially alter the OFT's proposed decision.
- 6 This decision is issued under the Act in accordance with rule 15 of the Director's rules. It states the facts on which the OFT relies and its reasons for the decision.⁵

B The parties

- 7 The arrangements were notified to the OFT by Pool Re. The other parties to the notified arrangements are the members of Pool Re and HM Treasury, which has entered into a retrocession agreement with Pool Re, under which HM Treasury indemnifies Pool Re's liability with respect to acts of terrorism as defined in the Reinsurance (Acts of Terrorism) Act 1993.⁶ Currently Pool Re has over 260

³ The details of the notification are set out on OFT's website at the following address: www.offt.gov.uk/Business/Competition+Act/Notifications/Pool+Reinsurance.htm

⁴ The Competition Act 1998 (Director's Rules) Order 2000, SI 2000 No 293. This is available at www.hmso.gov.uk/si/si2000/20000293.htm. As from 1 April 2003, the Enterprise Act 2002 transferred the functions of the Director General of Fair Trading to the OFT. The OFT now applies the Director's rules.

⁵ Rule 15(1)(a) of the Director's rules.

⁶ Under the notified arrangements, acts of terrorism are defined, in accordance with The

members comprising the vast majority of insurers which provide general cover in respect of commercial property⁷ in GB. The entry on the OFT's public register lists the Pool Re members as at the time of the notification.

C The notified arrangements

8 The notified arrangements relate to the establishment, organisation and operation of Pool Re and to its relationship with its members.

9 The notified arrangements comprise:

- *Memorandum and Articles of Association of Pool Re* (8 March 1993) establishing Pool Re.
- *Retrocession Agreement* (30 July 1993) entered into between the Secretary of State for Trade and Industry (subsequently replaced by HM Treasury) and Pool Re. If a member makes a claim against Pool Re under the Reinsurance Agreement, Pool Re is obliged first to exhaust its own funds, then to call for payments under any other commercial reinsurance contracts and finally to call for payment of any remaining shortfall from HM Treasury.⁸
- *Membership Agreement* (1 November 1993) entered into between Pool Re and its members. This agreement is intended to regulate the rights and liabilities of members between themselves and vis-à-vis Pool Re in their capacity as members.
- *Accession Agreement (and Pro Forma Form of Application for Membership)*, which sets out the terms upon which an insurer may become a member of Pool Re. It is supplemental to the *Membership Agreement*.

Reinsurance (Acts of Terrorism) Act 1993 Part 2(2), 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*'.

⁷ Under the notified arrangements, 'commercial property' includes flats and houses which are not insured in the name of an individual (e.g. houses or blocks of flats held by property or investment companies or trustees), property owned and insured in the name of an individual but for the purposes of a business activity unless such property is occupied by that individual as a private residence, and property which is partly in commercial use, provided that the commercially occupied proportion of the property exceeds 20 per cent.

⁸ Pool Re is obliged to pay a proportion of its premium income to HM Treasury (payable only once the accumulated funds of Pool Re exceed £1 billion).

- *Risk Excess of Loss Reinsurance Agreement ('the Reinsurance Agreement')* entered into between Pool Re as the reinsurer and each member as the reinsured.
- amended *Underwriting Manual* in effect since 1 January 2003, which is part of the contractual arrangements between Pool Re and its members and sets out the practices and procedures to be followed by each member in respect of the underwriting of terrorism risks on commercial property in GB.
- amended standard *Supplemental Deed* to the Reinsurance Agreement entered into by the Pool Re and each member.
- *Notice of particulars and prescribed form of legal opinion*, which are administrative documents.

II LEGAL AND ECONOMIC ASSESSMENT

- 10 The OFT sought information from a number of Pool Re members, competitors and insureds, concerning the impact of the Pool Re arrangements on competition. The purpose of the OFT enquiries was to assist the OFT to determine whether the notified arrangements are caught by the Chapter I prohibition of the Act and, if so, whether they might qualify for exemption.

A The relevant markets

Relevant product markets

- 11 The notified arrangements affect relevant markets at two levels. First, there are markets at the insurance level relating to the provision by insurers of insurance for commercial property to insureds, the final consumers. Second, there is a market at the reinsurance level relating to the provision of reinsurance services to these insurers. The scope of each of these markets is considered below.
- 12 Pool Re submitted that the relevant product market at the insurance level could be defined narrowly, as the market for the provision of direct insurance of terrorism cover for commercial property or more broadly, as the market for the provision of direct general insurance for commercial property. At the reinsurance level Pool Re identified the relevant market as the market for the provision of reinsurance of terrorism cover for commercial property.
- 13 The OFT accepts Pool Re's definition of the relevant reinsurance market but considers that the scope of the Pool Re arrangements impact on both the market for the provision of insurance of general cover (excluding terrorism cover) for commercial property and the market for the provision of insurance of terrorism cover for commercial property.

INSURANCE

- 14 The provision of insurance can be divided into two sectors – life and non-life. Furthermore, as indicated in a number of European Commission decisions under the EC Merger Regulation⁹, non-life direct insurance can be divided into as many product markets as there are different classes of insurance cover (for example accident, sickness, land vehicles, aircraft, damage to property) because their

⁹ Such as Commission Decision of 18 June 1996, IV/M.759 *Sun Alliance/Royal Insurance*, OJ [1996] C225/12 and Commission Decision of 28 February 2003 COMP/M.3035 *Berkshire Hathaway/Converium/Gaum/JV*, OJ [2003] C65/22.

characteristics, premiums and purposes are distinct and there is typically no demand-side substitutability for the insured between the different risks insured.

- 15 A distinction can be drawn between domestic and commercial property insurance as the risks related to the latter are subject to more diverse losses, reflecting the different underlying usage. The policies offered to commercial property owners generally provide an indemnity against losses sustained by the policyholder under a number of heads of cover, where such losses arise from the insured risks. Such heads of cover may include damage to the insured property itself and consequential losses, including loss of profit arising from business interruption.
- 16 On the demand side, commercial property owners seek to obtain insurance against material damage to their properties and business interruption resulting from perils such as fire and explosion. In defining the relevant market it is necessary to consider any viable alternatives ('substitutes') which might be sources of competitive constraint. For the owner of the commercial property, it is clear that the purpose of obtaining the insurance is to protect itself from the financial consequences of damage to that asset. Hence there are unlikely to be substitutes for that cover and general cover (excluding terrorism cover) for commercial property insurance can be seen as a distinct market.
- 17 Commercial property owners may also wish to obtain terrorism cover for their properties. However, as indicated above, general cover for commercial property offered by insurers excludes cover for terrorism events. Commercial property owners may request such cover either because they consider that they are at risk or because they are required to meet requirements for comprehensive insurance coverage contained in loan or leasing agreements. They might demand such terrorism cover either as an 'add on' to the general cover which they have already obtained or as a standalone product. Were pricing of such terrorism cover to rise by a small but significant degree above the competitive level it seems unlikely that property owners could find another product that meets their needs. Therefore it is likely that the provision of terrorism cover for commercial property is a distinct market.
- 18 On the supply side, it is clear that there is a well established market for the provision of insurance of general cover (excluding terrorism cover) for commercial property. However, the responses by insurers of general cover to the OFT enquiries indicate that in the absence of the availability of reinsurance, they would not be in a position to provide terrorism cover.

- 19 As indicated above, terrorism cover for commercial property can be provided on a standalone basis. Whilst the majority of insurers of general cover have indicated that they have no appetite to supply such cover on this basis there are certain specialist insurers who could potentially supply standalone terrorism cover. This could provide a competitive constraint to the pricing of the terrorism cover provided by insurers of general cover and hence it could be said that there is a distinct market for the provision of insurance of terrorism cover for commercial property
- 20 On the basis of the above, the relevant insurance markets are the market for the provision of insurance of general cover (excluding terrorism cover) for commercial property and the market for the provision of insurance of terrorism cover for commercial property.

REINSURANCE

- 21 Pool Re provides reinsurance against terrorism risks only for commercial property insurance in GB. Pool Re enables insurers to offer insureds insurance cover for terrorism risks as defined in the notified arrangements on payment of an added premium. This is provided via an extension clause to the standard general cover policy. In this way, cover against such terrorism risks is provided for by reinstating cover that would otherwise be excluded under the terms of the standard policy.
- 22 Reinsurance can be distinguished as a separate product market from insurance because of its purpose of spreading risk between insurers. Reinsurance is a service provided to insurers by reinsurers, whereas insurance is provided by insurers to insured parties. The reinsurer accepts either the whole or part of the direct risk insured by another insurer, allowing the direct insurer to increase the amount of insurance underwritten and to diversify risk. Reinsurance is traded between industry specialists and written only with other insurers. Hence there is no need for a retail distribution channel as there are no direct sales to the public.
- 23 The provision of reinsurance can be divided into two sectors – life and non-life. The non-life sector can be further sub-divided into different classes of insurance cover consistent with those of direct insurance indicated in paragraph 14 above.
- 24 On the demand side, it is clear that there is limited substitutability between the reinsurance of these different classes of business given their different characteristics. The responses to the OFT enquiries indicate that insurers require terrorism reinsurance to cover the commercial property insurance they write. On the supply side, in past European Commission decisions, it has been considered that there is a high level of supply-side substitutability between the reinsurance

of different types of covers. While some reinsurers specialise in particular types of cover, any reinsurer could easily switch reinsurance coverage from one type of risk to another.¹⁰ However, due to the particular nature and size of terrorism risk, and the reluctance of reinsurers to commit capital in areas which threaten their solvency, it could be argued that reinsurance of such risk may be regarded as a distinct product market within the broader (non-life) reinsurance sector.

25 In order to understand the particular characteristics of terrorism reinsurance, it is useful to examine how the market has developed in recent years. In the late 1990s there was some renewed reinsurance activity related to terrorism risks. However, as a result of the events in the United States on 11 September 2001, reinsurers once again withdrew from providing reinsurance of terrorism cover. The withdrawal of reinsurance cover led some insurers active in the Lloyd's market¹¹ to join Pool Re. The perceived threat from nuclear and biological contamination resulting from a terrorist event led insurers and reinsurers alike to adopt wider definitions of an act of terrorism for their policy exclusions.¹² The fact that Pool Re's definition of an act of terrorism¹³ is narrower than the definitions used by such insurers in framing their exclusions resulted in a gap in cover for certain insureds who sought a write back of terrorism cover into a general policy for commercial property. However, there is evidence from OFT enquiries to suggest that this gap is narrowing due to the emergence of reinsurers, other than Pool Re, which are willing to provide cover to fill some or all of the gap.

26 Reasons given for the withdrawal of global reinsurers from the provision of terrorism cover in GB and elsewhere include the difficulty in quantifying the risk for unpredictable events with catastrophic loss potentials. In comparing risks arising from terrorism events to those arising from natural catastrophes, an academic commentator¹⁴ has noted that the events in the United States on 11 September 2001 not only represent a new dimension to probable damage (for example impact by aircraft, chemical or biological contamination), but also a

¹⁰ For example, Commission Decision of 28 February 2003 COMP/M.3035 *Berkshire Hathaway/Converium/Gaum/JV*, OJ [2003] C65/22.

¹¹ Lloyd's of London is an institution within which individual underwriters accept or reject the risks offered to them.

¹² For example, in the Lloyd's market database an act of terrorism is defined as '*an act, including the use of force or violence, of any person or group(s) of persons whether acting alone or on behalf of or in connection with any organisation(s), committed for political, religious or ideological purposes including the intention to influence any government and/or to put the public in fear of such purpose*'.

¹³ As indicated in footnote 6, Pool Re adopts the definition of acts of terrorism set out in the Reinsurance (Acts of Terrorism) Act 1993 Part 2(2).

¹⁴ Michael Wolgast, '*Global terrorism and the insurance industry: new challenges and policy responses*' published in '*Insurance and September 11 one year after - impact, lessons and unresolved issues*' by the Geneva Association [2002].

very different origin to that damage. These special characteristics of terrorism risk make it difficult for reinsurers to underwrite (evaluate and price) such exposure. The desire of reinsurers to avoid accumulation on a massive scale combined with the necessity, at the present time, of state backing for the reinsurance of such risks, make it unlikely that competitors will emerge for the provision of reinsurance of terrorism cover for commercial property in GB.

- 27 Acts of terrorism involve intentional conduct. This creates a significant difference between the risks of terrorism and the risks of natural catastrophe. Natural hazards or technical accidents, irrespective of their dimension, occur randomly and without intent and their probabilities and consequences can be modelled with scientific data and methods. Where there is intent, as in the case of terrorism risks, such modelling becomes problematic. In that respect, terrorism has more in common with other political risks like war or civil unrest rather than with accidents or forces of nature. For these reasons, reinsurers are likely to consider terrorism reinsurance as different from other types of reinsurance. In addition difficulties in pricing losses related to a commercial property portfolio and the large accumulations that occur where property values are high may lead reinsurers to view the reinsurance of commercial property as distinct from other forms of terrorism reinsurance. Hence the OFT considers that the appropriate market definition is the market for the provision of reinsurance of terrorism cover for commercial property insurance.

Relevant geographic market

GREAT BRITAIN COMPRISING THE MAINLAND BUT NOT THE TERRITORIAL WATERS

- 28 Pool Re submits that the relevant geographic market at the insurance level is the territory of the United Kingdom, excluding Northern Ireland and the territorial waters (referred to here as 'GB') and that the relevant geographic market at the reinsurance level is international.
- 29 The non-life insurance markets are generally considered as national in scope in view of established market structures, the need for adequate national distribution channels for the sale of non-life insurance products to customers, fiscal constraints in some cases and differing national systems of regulatory supervision.¹⁵

¹⁵ See, for example, Commission Decision of 18 June 1996, IV/M.759 *Sun Alliance/Royal Insurance*, OJ [1996] C225/12 and Commission Decision of 20 December 1996, IV/M.862 *Axa/UAP*, OJ [1996] C38/6.

- 30 Reinsurance markets are usually considered as global in view of the need to pool risks on an international basis and the conduct of reinsurance business on a worldwide basis. However, in the case of terrorism reinsurance for commercial property, cover is generally provided only by national pools, such as Pool Re. The coverage of these schemes differs markedly but, due to the presence of state backing, each is based on reinsuring identified risks within national boundaries. Pool Re has delineated the national boundary in terms of GB rather than the United Kingdom, because a different state-backed scheme operates in Northern Ireland.¹⁶
- 31 The OFT considers that a national market definition (in this case GB) is appropriate for both the relevant insurance and relevant reinsurance markets. The Pool Re arrangements cover only the reinsurance of terrorism cover and insurance of general cover provided for commercial properties in GB. Commercial insurers operating outside GB will be unlikely to offer insurance that includes terrorism cover in GB unless they become members of Pool Re. State-backed reinsurance or insurance schemes based in other territories will not compete to provide terrorism cover for commercial properties in GB.

B The Chapter I prohibition

- 32 Section 2(1) of the Act sets out the Chapter I prohibition which provides that agreements between undertakings, decisions by associations of undertakings or concerted practices which (i) may affect trade within the United Kingdom,¹⁷ and (ii) have as their object or effect the prevention, restriction or distortion of competition within the United Kingdom are prohibited.

Agreements between undertakings, decisions by associations of undertakings and concerted practices

- 33 Pool Re is engaged in an economic activity, namely the provision of reinsurance cover to insurers for ceded risks in return for a premium. Pool Re members are also engaged in an economic activity, namely the provision of insurance cover to insureds for ceded risks in return for a premium. In the OFT's view Pool Re and its members constitute undertakings for the purposes of section 2 of the Act. Alternatively, Pool Re could be regarded as an association of undertakings.¹⁸ In

¹⁶ This scheme, based on the Criminal Damage (Compensation) Northern Ireland Order 1977, differs from the Pool Re scheme in that property owners receive direct compensation from HM Government in respect of damage arising from terrorist activity.

¹⁷ The United Kingdom includes any part of the United Kingdom where an agreement operates or is intended to operate.

¹⁸ Commission Decision of 14 January 1992, IV/33.100 *Assurpol*, L37/16.

the OFT's view the Retrocession Agreement does not contain any restrictive provisions falling within the Chapter I prohibition of the Act and it is therefore not necessary, for the purposes of this decision, to consider whether HM Treasury constitutes an undertaking in its capacity as a party to the Retrocession Agreement.

- 34 The OFT considers that the notified arrangements, with the exception of the Retrocession Agreement, constitute agreements between undertakings within the meaning of section 2 of the Act. Alternatively, the notified arrangements could be regarded as decisions by an association of undertakings. For the reasons set out in paragraph 33, the OFT does not consider it necessary to reach a view as to whether the Retrocession Agreement constitutes an agreement between undertakings for the purposes of section 2 of the Act.

Effect on trade within the United Kingdom

- 35 The notified arrangements regulate a substantial part of the provision of the reinsurance of terrorism cover and the insurance of terrorism cover for commercial property in GB and have an impact on the provision of insurance of general cover for commercial property in GB. The arrangements therefore have an effect on trade within the United Kingdom within the meaning of section 2 of the Act.

The prevention, restriction or distortion of competition in the United Kingdom

- 36 The OFT has considered below whether the following features of the notified arrangements give rise to appreciable competition concerns within the meaning of the Chapter I prohibition.

THE POOLING ARRANGEMENTS

- 37 Pool Re is a reinsurance pool set up by insurers to mutually reinsure all of their liabilities in respect of defined terrorism risks, above a defined retention level.¹⁹ Membership of Pool Re is open to any corporation authorised by the state in which it is resident to carry on general insurance business and which insures risks situated in GB and to any underwriter of a Lloyd's syndicate²⁰ which writes general insurance business in GB. Pool Re members are subject to standard non-

¹⁹ Pool Re reinsures its members' liabilities in excess of a specified sum which is the retention. Individual 'per event' retention and 'annual aggregate' retention are calculated annually for each Pool Re member, in proportion to the member's participation in the Pool Re scheme.

²⁰ A Lloyd's syndicate is a consortium of individual Lloyd's of London underwriters, where usually one person acts for the syndicate in accepting risks or rejecting them.

discriminatory terms. Pool Re has adopted a simple tariff structure²¹ based on the geographic location of the risks held by insurers for the calculation of their reinsurance premiums. The Terrorism Cover provided by the members must be subject to the same terms and conditions as the relevant General Cover. Pool Re members are free to set their insurance premiums but the scope of the Terrorism Cover offered by Pool Re members to insureds must be at least as wide as that provided to the insurers by Pool Re under the Reinsurance Agreement.

38 In past decisions under Article 81 of the EC Treaty in the insurance sector,²² the European Commission has considered that a co-insurance pooling agreement is not anti-competitive when it is '*necessary to allow its members to provide a type of insurance that they could not provide alone. There cannot be a restriction of competition when the members of the pool are not actual or potential competitors, because they are unable to insure alone the risks covered by the pool. If anything, such [agreement] indeed strengthens competition since it allows several insurers which are not able to provide such cover to put their resources in common and create a new player.*'

39 The OFT considers that in the absence of a co-reinsurance pooling arrangement such as Pool Re, insurers would not be able to offer insurance of terrorism risk for commercial properties in GB at the level required (in terms of insured value). The aim of Pool Re is to 'plug the gap' in the reinsurance market for commercial property by ensuring that coverage is available for all commercial property, at affordable prices. The application of the scheme is limited to properties located within England, Wales and Scotland; this mirrors the scope of the terrorism exclusion introduced by the insurers in 1992. The Pool Re arrangements are intended to be temporary and HM Treasury's intention is to withdraw from the Pool Re arrangements as soon as adequate sources of commercial reinsurance cover are available. However, responses to the OFT enquiries suggest that, in the short term, there is a limited prospect of alternative providers re-emerging to meet the needs of commercial insureds on the level required.

40 Evidence from the OFT enquiries indicates that, currently, there is limited capacity from reinsurers and insurers for the reinsurance and insurance of terrorism cover for commercial property in GB, but that this capacity only relates to cover for some properties in specified locations.

²¹ The simple tariff structure sets out a single rate for 'business interruption' and two rates for 'property damage' (four zones based on GB postal codes are identified to which one of these two rates apply).

²² Commission Decision of 12 April 1999, IV/D-1/30.373 *P&I Clubs, IGA* and IV/D-1/37.143 *P&I Clubs, Pooling Agreement*, OJ [1999] L125/12: these cases concerned a claim-sharing arrangement between insurance mutuals (the equivalent of a pool in the non-profit insurance sector).

- 41 Due to the specific characteristics of terrorism risks relating to commercial property (i.e. they are of a catastrophic nature, tending to occur rarely but involving very large liabilities when they do occur), no individual insurer is capable of insuring such risks alone at the level of cover required. This view is supported by evidence which indicates that insurers are reluctant to provide insurance cover for terrorism events without reinsurance cover, as the absence of statistically reliable loss history and the inability to project future losses means that technical or scientific approaches to the assessment of the likelihood of a terrorist event are likely to fail. Given this uncertainty, if terrorism insurance were to be offered at all in the absence of Pool Re, it is likely that insurers would, for the most part, set the prices either prohibitively high or so low as to invite insolvency.²³
- 42 A co-reinsurance pool is therefore necessary in order to allow its members to operate in the relevant insurance market and to offer coverage of terrorism risks for all commercial property in GB. Therefore, the OFT has concluded that the pooling of terrorism reinsurance capacity, in itself, does not prevent, restrict or distort competition. It therefore falls outside the Chapter I prohibition.

TERRORISM COVER TO BE OFFERED ONLY IN CONJUNCTION WITH GENERAL COVER²⁴

- 43 Section 1.02 of the Underwriting Manual provides that Pool Re members shall not offer insurance of Terrorism Cover, unless such cover attaches to the relevant insurance of General Cover.
- 44 The responses of insurers to the OFT enquiries suggest that it is usual industry practice to offer coverage of a particular peril (e.g. caused by terrorism) alongside primary material damage cover. However, it has been suggested that terrorism cover could be offered on a standalone basis, meaning that separate policies could be underwritten by insurers to cover commercial properties against damages arising from acts of terrorism.
- 45 This rule prevents Pool Re members from offering Terrorism Cover to insureds on a standalone basis. As a result, insureds are unable to buy 'unbundled' Terrorism Cover. While there is competition between Pool Re members for the provision of Terrorism Cover with General Cover, the requirement to sell Terrorism Cover only in conjunction with General Cover to some extent limits

²³ US Government Accounting Office [2001], '*Terrorism Insurance: Alternative Programs for Protecting Insurance Consumers*'.

²⁴ 'General Cover' is defined in paragraph 2 above.

the ability of insureds to negotiate prices for the separate elements of general cover for commercial property.

- 46 The rule also has a restrictive effect on competition by restricting the opportunities for insurers which are not members of Pool Re to sell General Cover for commercial property. Insureds cannot obtain General Cover outside Pool Re for the commercial properties for which Terrorism Cover is provided by a Pool Re member.
- 47 The rule requiring Pool Re members to offer Terrorism Cover only in conjunction with General Cover therefore deprives insureds of their ability to purchase Terrorism Cover on a standalone basis, reduces competition between insurers as to the terms and conditions on which they supply insureds with Terrorism Cover for commercial property, and limits the scope for insurers which are not Pool Re members to offer General Cover.
- 48 In light of the above, the OFT has concluded that this rule prevents, restricts or distorts competition.

SHARE OF THE SURPLUS

- 49 The Pool Re arrangements make provision for members to participate in Pool Re's assets in the event of its being wound up, by allowing each of them to receive a share of the surplus.²⁵ Members remain eligible to share the surplus for a period of three years after their withdrawal from Pool Re, during which period they are allowed to provide terrorism reinsurance or insurance independently of Pool Re.
- 50 On 31 December 2002, the accumulated funds within Pool Re amounted to £1.3 billion. It could be argued that the prospect of a share of the Pool Re surplus may create incentives for members to maintain their membership of Pool Re longer than they would otherwise, which in the long run may deter the re-emergence of a competitive market for the reinsurance of terrorism cover.
- 51 However, the fact that members remain eligible to share the surplus for a period of three years after leaving Pool Re, during which time they can provide insurance for terrorism cover independently of Pool Re, lessens the likelihood that it will constitute a barrier to exit from Pool Re. In addition, responses by

²⁵ The share of the surplus that each Pool Re member is entitled to is equal to the proportion which its premium payments in the last three underwriting periods prior to the winding up represented of the total premium paid to Pool Re during that period.

Pool Re members indicated that the surplus is not a main factor in determining whether or not to remain a member of Pool Re.

- 52 In light of the above, the OFT has concluded that this rule does not prevent, restrict or distort competition and falls outside the Chapter I prohibition.

THE REQUIREMENT NOT TO SELECT AGAINST POOL RE ('NO ADVERSE SELECTION' RULES)

- 53 Two rules prevent insurers and insureds from selecting against Pool Re.
- **The 'cede all business' rule:** this rule, set out in Article 10.1(c) of the Reinsurance Agreement requires Pool Re members and their group companies to reinsure all of their Terrorism Cover with Pool Re.
 - **The 'all or nothing' rule:** according to this rule, set out in Section 1.07(A) of the Underwriting Manual, if an ultimate insured wishes to insure any of its properties for Terrorism Cover with a member of Pool Re, then the member must require the insured to buy such Terrorism Cover for all properties for which it buys General Cover.
- 54 Pool Re has explained that the objective of these two rules is to protect Pool Re against 'adverse selection' or the 'cherry picking' of risks, meaning a situation in which (i) members cede to Pool Re only the worst risks and offer alternative terrorism cover (not ceded to Pool Re) for the risks which they are prepared to carry themselves, or (ii) insureds insure only their worst risks. The rules are aimed at ensuring that Pool Re has a minimum scale and spread of risk to operate effectively.
- 55 The OFT has concluded that these 'no adverse selection' rules prevent, restrict or distort competition for the following reasons.

The 'cede all business' rule

- 56 This rule amounts to an exclusivity agreement since pool members are under a contractual obligation to reinsure all of their insurance of Terrorism Cover for commercial property with the pool. The rule prohibits the placing of reinsurance of Terrorism Cover outside the pool. The rule may have the effect of foreclosing the market for reinsurance of terrorism cover for commercial property in GB and making it very difficult for competitors to enter the market, since substantially all insurers who are active in GB and provide general cover in respect of commercial property in GB are members of Pool Re.

- 57 The OFT enquiries suggest that, currently, there is limited alternative provision of reinsurance of terrorism cover for commercial property in GB. The enquiries also indicate that there is little prospect of significant alternative providers re-emerging in the short term, due to the unwillingness of reinsurers to assume terrorism risks in the current climate of terrorism threat. A global reinsurer indicated that there remain difficulties in pricing exposure to such risks and, given continued uncertainty and the fact that the capacity of the global reinsurance market remains severely constrained, any cover that is offered is likely to be expensive.
- 58 The OFT considers that the 'cede all business' rule has the effect of restricting potential competition on the market for the reinsurance of terrorism cover for commercial property, which might otherwise emerge if, for instance, the current level of terrorism threat were to recede. The rule has the effect of reducing the incentive for insurers to look elsewhere for reinsurance, thereby making it more difficult for new market entrants to acquire business.
- 59 The rule also has the effect of restricting the market at the insurance level by preventing Pool Re members from offering terrorism cover for commercial property outside Pool Re. Prior to 11 September 2001, the number of insurers providing terrorism cover outside Pool Re was more significant, but the recent climate of terrorism threat led most of such providers to join Pool Re. As a result of the rule, all Pool Re members, including such new joiners, are now restricted in their ability to provide terrorism cover outside Pool Re.
- 60 In light of the above, the OFT has concluded that this rule prevents, restricts or distorts competition.

The 'all or nothing' rule

- 61 Under this rule, Pool Re members must require customers buying Terrorism Cover to buy such cover for all the properties for which they buy General Cover. This rule has a restrictive effect on the market at the insurance level.
- 62 The rule reduces competition between insurers as to the terms and conditions on which they supply insureds with Terrorism Cover for commercial property and deprives customers of their right to choose which properties to insure against terrorism risks.
- 63 The rule has also the effect of restricting the market at the insurance level and making it difficult for insurers which are not members of Pool Re to compete

with Pool Re members, for instance by providing terrorism cover for selected properties.

- 64 The responses to the OFT enquiries show that there is some limited supply of insurance for terrorism cover for commercial property in GB provided by insurers which are not members of Pool Re.
- 65 In light of the above, the OFT has concluded that this rule prevents, restricts or distorts competition.

Appreciability

- 66 An agreement or decision by an association of undertakings will be caught by the Chapter I prohibition if it has as its object or effect an appreciable prevention, restriction, or distortion of competition in the United Kingdom. The OFT takes the view that an agreement or decision by an association of undertakings will generally have no appreciable effect on competition if the parties' combined share of the relevant market does not exceed 25 per cent²⁶, although there will be circumstances in which this is not the case.
- 67 Pool Re is virtually the only provider of terrorism reinsurance for commercial property in GB and substantially all insurers providing general cover in respect of commercial property in GB are members of Pool Re. The rule requiring Pool Re members to offer Terrorism Cover only in conjunction with General Cover and the 'no adverse selection' rules are therefore likely to have an appreciable effect on competition within the United Kingdom in the relevant markets, as defined above. These rules are therefore caught by the Chapter I prohibition.

Exclusions

VERTICAL EXCLUSION

- 68 Pool Re contends that the various agreements entered into between Pool Re and its members (including the Reinsurance Agreement and the Underwriting Manual) and the Retrocession Agreement, should be regarded as vertical agreements which benefit from the exclusion from the Chapter I prohibition for vertical agreements²⁷ (the 'verticals exclusion').

²⁶ OFT Guideline 401, *The Chapter I Prohibition*, March 1999, paragraphs 2.18 and 2.19.

²⁷ Competition Act 1998 (Land and Vertical Agreements Exclusion) Order 2000, SI 2000/310.

- 69 The OFT has identified restrictions of competition in the Reinsurance Agreement and the Underwriting Manual. These agreements are not individually negotiated between Pool Re and each member. Instead, each member signs up to a set of standard agreements which govern the activities of all members of Pool Re.
- 70 In order to benefit from the verticals exclusion, an agreement cannot involve more than one undertaking operating at the same level of the production or distribution chain. Since, by joining Pool Re, each member is, in effect, signing up to a single agreement which also applies to all other members of Pool Re, the OFT considers that the various agreements between Pool Re and its members constitute agreements which include more than one undertaking operating at the same level. Therefore, the Reinsurance Agreement and the Underwriting Manual should be regarded as horizontal agreements entered into by all Pool Re members and cannot benefit from the verticals exclusion. Alternatively, the Reinsurance Agreement and the Underwriting Manual could be regarded as decisions by an association of undertakings,²⁸ which also could not benefit from the verticals exclusion.

SERVICES OF GENERAL ECONOMIC INTEREST EXCLUSION

- 71 Pool Re argues that the Pool Re arrangements taken as a whole should benefit from the exclusion from the Chapter I prohibition and from the Chapter II prohibition for services of general economic interest (the 'SGEI exclusion').²⁹
- 72 In order to benefit from the SGEI exclusion the Pool Re arrangements must (i) involve an undertaking, (ii) which has been entrusted by the state or a public authority with (iii) a service of general economic interest, and (iv) any restrictions on competition must be no more than what is necessary to allow Pool Re to perform the service entrusted to it.
- 73 The OFT is not satisfied that Pool Re has been entrusted with a service of general economic interest. In order to meet condition (ii) above, there must have been an act of entrustment by the state or a public authority of the performance of a service. Mere approval by the state or a public authority of the activities carried out by an undertaking is not sufficient.³⁰ The OFT doubts that the financial relationship between HM Treasury and Pool Re is such as to amount to the entrustment of the performance of a service of general economic interest.

²⁸ Commission Decision of 14 January 1992, IV/33.100 *Assurpol*, L37/16.

²⁹ Schedule 3, paragraph 4, Competition Act 1998.

³⁰ Commission Decision of 10 December 1984, IV/30.717 *Uniform Eurocheques*, L35/43.

74 On the facts of this case, the OFT is therefore not satisfied that the conditions for the application of the exclusion are met.

Conclusion

75 For the reasons set out above, the OFT has concluded that the rule requiring Pool Re members to offer Terrorism Cover only in conjunction with General Cover, the 'cede all business' rule and the 'all or nothing' rule have the effect of preventing, restricting or distorting competition to an appreciable extent. These rules are therefore caught by the Chapter I prohibition.

C Individual exemption

Grounds for exemption

76 Under section 4 of the Act the OFT may grant an individual exemption from the Chapter I prohibition to an agreement or a decision by an association of undertakings, where a request for exemption has been made under section 14 by a party to the agreement or decision by an association of undertakings.

77 An agreement or a decision by an association of undertakings that is caught by the Chapter I prohibition will qualify for an individual exemption if it meets the criteria set out in section 9 of the Act. Section 9 applies to any agreement or decision by an association of undertakings which:

- contributes to improving production or distribution, or promoting technical or economic progress;
- while allowing consumers a fair share of the resulting benefit;
- but does not impose on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives; or
- afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the products in question.

78 The OFT has decided to grant an individual exemption in respect of the rule requiring Pool Re members to offer Terrorism Cover only in conjunction with General Cover, the 'cede all business' rule and the 'all or nothing' rule.

Exemption criteria

IMPROVING PRODUCTION OR DISTRIBUTION OR PROMOTING TECHNICAL OR ECONOMIC PROGRESS

- 79 The overall objective of the notified arrangements is to ensure the continued availability of insurance cover for damage and loss which might be caused to commercial property in GB by acts of terrorism. Crucially, in the absence of the Pool Re scheme, it seems unlikely that this type of insurance would be widely available.
- 80 The contribution of insurance to economic progress has been described as follows: *'Through a reduction or absorption of some of the risks associated with the process of production, insurance enables risk-adverse entrepreneurs to take on entrepreneurial risks to a much greater extent than would be the case in the absence of insurance'*.³¹
- 81 It seems likely that the availability of terrorism cover facilitates investment in business and construction, in particular by reducing the risks attached to such activities. Terrorism cover is in fact generally required to allow insureds to meet requirements set out in loan and tenancy agreements. Responses to the OFT enquiries indicate that terrorism insurance coverage is dictated by finance providers or lessors who insist that 'full' material damage cover is available on all locations to protect their financial interests.
- 82 In addition, terrorism cover ensures that businesses that suffer from a terrorist event are more likely to be able to survive, thus minimising the adverse economic impact of the event and improving economic progress.
- 83 Hence economic progress is enhanced by the availability of terrorism cover for commercial property. The OFT has concluded that the Pool Re scheme fulfils the first exemption criterion.

CONSUMERS ALLOWED A FAIR SHARE OF THE RESULTING BENEFIT

- 84 The Pool Re scheme enables its members to provide Terrorism Cover as part of a policy of general cover for commercial property.
- 85 The benefit of the notified arrangements to the end-consumer of the Pool Re scheme, i.e. the original insured, is the availability of terrorist coverage which,

³¹ Michael Wolgast, op. cit. (footnote 14), p 248.

as indicated above, is often required for insureds to comply with financing or lease provisions as well as being desirable more generally. Terrorism cover is provided by general insurers on an annual basis with almost immediate cancellation conditions. In the absence of Pool Re, this can result in a high degree of volatility as reinsurers react quickly to changes in perceived terrorism threats. Hence, property owners would face price volatility and cover may not be available from one year to the next, which would make financial planning extremely difficult.

- 86 The existence of Pool Re provides insureds with greater certainty that terrorism cover will be available from one year to the next, at prices that are affordable, irrespective of the location of the property. The end-consumer benefits from the full extent of the reinsurance cover available to the insurer member within the Pool Re scheme as the member is required to provide the same scope of cover to the original insured and cannot exclude liability where Pool Re would otherwise meet the claim. In response to OFT enquiries insureds also indicated that a major benefit of Pool Re was the certainty afforded by the assurance that coverage will remain in place irrespective of whether there is heightened terrorist activity.
- 87 In light of the above, the OFT has concluded that the scheme fulfils the second exemption criterion.

INDISPENSABILITY OF THE RESTRICTIONS

The rule requiring Pool Re members to offer Terrorism Cover only in conjunction with General Cover

- 88 The Pool Re scheme was established to 'plug the gap' that appeared in the market following the exclusion of cover in general policies of liabilities for losses arising from acts of terrorism. By providing Terrorism Cover through a mechanism of write-back into a policy of general cover, the scheme's aim is to restore the scope of general cover for commercial property provided to insureds. In this, the rule reflects long-standing market practice: responses by insurers to the OFT enquiries suggest that it is market practice to offer coverage of a particular peril (e.g. caused by terrorism) alongside primary material damage cover.
- 89 Pool Re contends that the rule is indispensable to meet the Government's public interest objective of ensuring the widespread availability of Terrorism Cover and encouraging commercial insurers and reinsurers to reassume liability for terrorism risk. The rule has the effect of ensuring that Pool Re members are general

insurers with a diverse portfolio of insured properties for which Terrorism Cover is available. To maintain their competitive position general insurers who are not in the Pool Re scheme are attracted to join to ensure that they too can offer their customers a comprehensive coverage of risks.³² The fact that over 260 insurers have joined Pool Re indicates the strength of this incentive. Pool Re contends that such a wide distribution of the terrorism product could not be achieved through narrower distribution channels. Moreover there are benefits that flow from this in terms of the volume of premium and diversification which are important to the sustainability of the pooling arrangements. In addition, the rule results in the widespread familiarisation amongst general insurers with the provision of Terrorism Cover which is an essential component in encouraging commercial capacity back into the market.

- 90 The OFT accepts the arguments advanced by Pool Re and, for the reasons set out above, has concluded that the rule requiring Pool Re members to offer Terrorism Cover only in conjunction with General Cover satisfies the indispensability criterion.

The 'no adverse selection' rules

- 91 With regard to the 'no adverse selection' rules, it is a normal principle of the (re)insurance business that (re)insurers will require or, at the very least, seek to ensure that they are not selected against, i.e. that risks presented to them are not atypical when compared with the assumptions they make in deciding the price and terms on which the business has been accepted.
- 92 This is particularly the case where the reinsurer is committed, as is Pool Re, to underwrite on standard terms all reinsurance (within a given definition) presented to it. Under a typical reinsurance agreement, a reinsurer would normally ensure a balanced portfolio by setting its reinsurance rate against the risks in the underlying portfolio of the insurer. However, in the case of terrorism risks, modelling is difficult and research suggests that underwriters are so averse to ambiguity that they tend to charge much higher premiums than if the risks were well specified.³³ For this reason, Pool Re has adopted a simple tariff structure for its reinsurance premium which sets out a single rate for 'business interruption' and two rates for 'property damage' (four zones based on GB postal codes are identified to which one of these two rates apply). The objective of this simple

³² Pool Re members are required to provide Terrorism Cover when requested to do so by any insured already having or requesting General Cover. Although Pool Re members are subject to a 'must write' obligation in relation to Terrorism Cover, they are free to set their insurance premiums and the policy terms and conditions.

³³ Kunreuther, Meszaros, Hogarth and Spranca, (1995), *Ambiguity and underwriter decision process*, Journal of Economic Behaviour and Organisation 16, p337-352.

tariff structure is to determine, on a uniform basis, the cost of reinsurance objectively by reference to the risks introduced into the pool.

- 93 Without the 'adverse selection' rules, insurers could 'cherry pick' by choosing only to reinsure those risks that they consider are the greatest. The responses to the OFT enquiries indicate that Pool Re members acknowledge the need for Pool Re to retain a balanced portfolio of risk. They view the 'cede all business' rule as customary where there is a 'treaty arrangement', i.e. a form of reinsurance coverage in which there is an automatic reinsurance for an insurer against losses that exceed a predetermined loss limit. The 'all or nothing' rule also appears to be necessary to ensure a balanced portfolio of risk for Pool Re, in order to prevent insureds from insuring with Pool Re members only those risks that they consider are the greatest.
- 94 If insurers and insureds were able to select against Pool Re, this could significantly reduce the number of risks in the pool and threaten the sustainability of the pooling arrangements. It is possible, moreover, that HM Treasury may not be willing to provide unconditional backing to Pool Re in the absence of the 'no adverse selection' rules because the public purse would then be exposed to the risk of cherry picking.³⁴
- 95 In conclusion, if the reinsurer is prepared to carry a 'must write' obligation on standard terms, it must be protected from adverse selection. Hence, the 'no adverse selection' rules appear to be necessary to enable Pool Re to generate a wider and more balanced portfolio of business, capable of funding claims on a sustainable basis. For this reason, the OFT has concluded that the 'no adverse selection' rules satisfy the third exemption criterion.

NO ELIMINATION OF COMPETITION

- 96 The Pool Re scheme does not eliminate competition in the market for the provision of reinsurance of terrorism cover for commercial property and in the relevant markets at the insurance level, since:
- (i) there is no obligation on any insurer to join Pool Re;
 - (ii) membership of Pool Re is open to any corporation authorised by the state in which it is resident to carry on general insurance business and which insures risks situated in GB, and to any underwriter of a Lloyd's syndicate which writes general insurance business in GB;

³⁴In this regard, see the statements made in the House of Commons debate on the Reinsurance (Acts of Terrorism) Bill, Hansard, 13 May 1993, cols 970-971.

- (iii) Pool Re applies standard non-discriminatory terms to its members for the provision of terrorism reinsurance;
- (iv) Pool Re members may withdraw from the Pool Re scheme on giving a notice period of 90 days and there are no significant barriers to withdrawal from Pool Re;
- (v) Terrorism Cover may be issued by members only for a period not exceeding 12 months;
- (vi) there is evidence that some (re)insurers which are not members of Pool Re participate, to a limited extent, in the market in competition with Pool Re and its members; and
- (vii) the levels of the retentions to be borne by each member,³⁵ which will increase over time, aim at encouraging commercial capacity back into the market. Pool Re has indicated that the increase will be phased in, in order to allow the market to get used to the new arrangements gradually and to allow substantial time for the reinsurance market to re-establish terrorism capacity.

³⁵ For a definition of the retention, see footnote 19.

III DECISION

- 97 The OFT has concluded that the rule requiring Pool Re members to offer Terrorism Cover only in conjunction with General Cover, the 'cede all business' rule and the 'all or nothing' rule satisfy the exemption criteria set out in section 9 of the Act.
- 98 On the basis of the facts and for the reasons set out above, the OFT has decided, pursuant to section 14 of the Act, to grant an individual exemption from the Chapter I prohibition in accordance with section 4 of the Act, for a period of three years from the date of this decision. However, the OFT considers that the grounds for exemption are likely to continue to exist after such date, unless there is a significant change in market circumstances, which might lead to the re-emergence of competing terrorism reinsurers at the level of cover required.
- 99 The OFT has decided also that the remainder of the notified arrangements do not contain restrictions that are likely appreciably to prevent, restrict or distort competition within the meaning of the Chapter I prohibition.

John Vickers.

John Vickers
Chairman