Client Briefing: Flood Insurance
16 January 2014

After much protracted discussion over the past year or so on the subject of flood insurance, the outcome is that the Government and UK insurers have agreed to develop a not-for-profit flood fund in the form of a mutual reinsurance company (Flood Re). It is designed to last for 25 years and effectively has two key principles: (1) it will limit the amount that high-risk households have to pay its insurer members for the flood component of their home insurance (the maximum amount that a home owner will have to pay for the flood component of their home insurance will be capped by reference to the council tax band within which the property falls, so that owners of smaller homes will not have to pay as much for flood insurance as those in larger homes); and (2) the flood component of the premium will provide a fund to reinsure all floods up to a "once in two hundred years" event, i.e. 99.5% of floods. The homeowner will buy home insurance as usual and the insurer can decide whether to cede the policy to Flood Re. In a situation where the homeowner makes a flood claim on a policy which has been ceded to Flood Re, the insurer will pay the claim directly and be reimbursed by Flood Re. On the Government's current estimation, it is expected that around 500,000 high-risk households would benefit from this scheme.

In June 2013, the Government and ABI agreed a Memorandum of Understanding ("MoU") on how to develop Flood Re. According to the ABI press release at the time, the key aspects of Flood Re are:

- Premiums for the flood risk will be calculated based on council tax banding up to a maximum limit depending on the Band.
- Flood Re would charge member firms (insurers) an annual charge of £180million. This equates to a levy of £10.50 on annual household premiums and represents the estimated level of cross-subsidy that already exists between lower and higher flood risk premiums.
- Flood Re will be designed to fully deal with at least 99.5% of years. Even in the worst half a per-cent of years, Flood Re will cover losses up to those expected in a 1 in 200 year – a year six times worse than 2007.

The mechanism for introducing Flood Re and the ability to confer powers on the Government to regulate the insurance industry to ensure that it provides affordable flood insurance if Flood Re fails (the "Flood Insurance Obligation") is by way of legislation – the Water Bill. This was published in June 2013.

The Water Bill included a placeholder for clauses on flood insurance whilst the Government consulted on them and their proposals for the future of flood insurance. The Government issued its first consultation on 27 June 2013 seeking views on its proposals for the future availability and affordability of home insurance in areas of flood risk; the consultation closed in August 2013. In September the Government published the draft clauses for inclusion in the Water Bill together with commentary for further discussion with the industry. A short informal consultation was undertaken between 6 and 20 September for the Government to seek views on the draft clauses. On 18 November 2013 the Government published its response to both the June consultation and informal September consultation on the draft clauses. Two briefing notes (19 November 2013 and 12 December 2013) have been subsequently published by DEFRA, explaining what the Government is doing in relation to flood insurance in the Water Bill and why.

On 17 December 2013 the Water Bill completed its Committee Stage in the House of Commons, having been debated on several occasions between 3 and 17 December. The placeholder clause (clause 47) for the flood insurance provisions was replaced with the flood insurance clauses (now clauses 51 to 71) and a number of issues surrounding Flood Re were debated (Committee Stage Report). As at the date of this note, the current version of the Water Bill, as amended in Public Bill Committee and brought from the Commons can be accessed on the Parliament website here. The Bill has now reached the House of Lords and the second reading is due to take place on 27 January 2014 when there will be a general debate on all aspects of the Bill.

It is worth mentioning the following points:

The Flood Insurance Obligation – The Water Bill includes provision for a situation whereby Flood Re fails to meet its objective and this is the Flood Insurance Obligation. Under the Obligation, there will be UK-wide register of properties at high risk of flooding with the ability to opt in and out of the register. Insurers would be allocated a quota of higher-risk properties to cover from this register with the allocations of higher-risk properties based upon the insurer's market share. It is with this in mind that the ABI has agreed to provide to the Government by January 2014, and then continue to maintain, a national database of individual property-level flood claims.

Excluded from Flood Re – Controversially, there are some types of properties that are excluded from being covered by Flood Re. These are:

- SMEs (small businesses such as bed and breakfasts) are currently excluded from Flood Re despite being included under the Statement of Principles (although any business based in a property that is primarily a residential property, and on which the occupier pays council tax, will be included).
- Band H council tax properties are also excluded on the basis that the Government believes that such homeowners would be able to afford flood insurance.
- Homes built after 1 January 2009 will not be covered by Flood Re and this is to "avoid any potential incentives to build homes in areas of flood risk".
- Genuinely uninsurable properties will also be excluded. However, work still needs to be done in defining what constitutes a "genuinely uninsurable property" (during the Committee Stage it was noted that "*the concept of uninsurability will emerge as Flood Re operates*" and that whilst "*there are no plans to exclude those at the highest risk at the outset…. we must have a way of considering properties that repeatedly flood and draw disproportionately on the funds of Flood Re*").

Funding – Together with the premium for the ceded policies, the fund will be financed by a statutory levy agreed between Flood Re and the Government. The levy is a one off annual payment and has been initially set at £180million per annum across the industry. It will be met by home insurance premiums paid by all homeowners (not just those at higher risk of flood damage) and it equates to approximately £10.50 (for the first five years of the scheme) for each UK household with both buildings and contents insurance. The levy will be used (in addition to Flood Re's premium income) to purchase reinsurance, pay claims and fund the running of Flood Re. The government has refused to give any guarantee to the fund at any point during its lifespan and yet there is no cap to insurers' exposure to flood risks. This has given rise to questions such as what happens if the fund is needed within the first year? Funding is required to set up Flood Re in the short term before it becomes self-funding a few years after creation. Getting the fund to a level which can cope with a flood disaster will take more than a year, so what will be the position if the fund is required during its first year? Another question that has been debated is how will the fund deal with the situation when the 1 in 200 year flood occurs (exhausting the fund) only to be followed by minor flood losses coming in soon after that? Also, if there are a series of less serious (than the 1 in a 200 year period flood) floods in a relatively short time this will also potentially drain the fund and leave insurers high and dry. The Government recognises that given the unpredictable nature of flood damage, there might be circumstances where Flood Re faces a shortfall.

Thus, there are provisions in place so that should Flood Re's funds and reinsurance cover be unable to fully meet its outgoings, Flood Re would charge its member firms an additional amount to make up the shortfall – a "top-up levy". It has been proposed that the top-up levy contributions could be paid back to insurers if in future years the fund builds up a sufficient surplus.

Private company or public body? Another area of uncertainty has been the status of Flood Re. According to the December 2013 briefing note, the Government has confirmed that Flood Re will be established as an industry-owned and managed body but because some or all of its expenditure will be public expenditure it will be necessary to have controls in place to control its finances and ensure accountability is clear. (The levy will make up a large part of its income and it is likely that the Office of National Statistics would consider some or all of Flood Re's funding as tax thereby some or all of its expenditure as public expenditure). Government's proposals are:

- Flood Re would be operationally independent.
- Flood Re would be directly accountable to Parliament for the detail of its operations.
- Relevant Ministers would be accountable to Parliament concerning general policy matters relating to flood insurance.
- Defra's accounting officer would be accountable to Parliament for the net expenditure for Flood Re.
- Flood Re will be required to appoint a Responsible Officer (expected to be its CEO) who will be directly accountable to Parliament for the economy, efficiency and effectiveness with which it uses its resources in the discharge of its functions.
- Flood Re would be required to lay its accounts in Parliament, prepared to the standards required of private companies and audited as representing a true and fair view.
- The level of the annual statutory levy and certain aspects relating to Flood Re's finances (such as borrowing, losses and accounting) will be regulated because of the potential impact on public finances – this is currently the subject of discussions between the Government and the insurance industry.
- Flood Re would be regulated by the FCA and PRA (as a body established and run by the private sector and functionally fully as a reinsurance company).
- It is intended that the Government will, every five years, assess the levy and eligibility thresholds.

Given that these skeleton details were put forward in the December briefing note, there is still a long way to go in setting up Flood Re as a legal body which leads to the question of whether Flood Re will be operational, as currently anticipated, by summer 2015.

Until the implementation of Flood Re the Government and insurance industry have agreed that the 2008 Statement of Principles will be rolled over. However, 2014 will continue to see debate between both sides on the controversial issues which may well lead to delay in finalising the general operational structure of Flood Re. Further, we are not aware of any steps that have been taken in respect of making a State Aid notification to the EU (State Aid notifications are required when taxpayer-funded resources are used to provide assistance to one or more organisations in a way that gives an advantage over others - Member State governments are obliged to notify all state aids to the European Commission before they are put into effect). According to the Committee Stage Report, the Flood Re proposals are seen to amount to "State Aid" and the notification process is expected to begin in 2014. This process can take up to 2 years before EU approval is given.

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FURTHER INFORMATION & TRAINING

For more information or to enquire about any training requirements that you may have in relation to this subject please contact the person with whom you usually deal or Sara Bradstock.