Department
for Environment
Food & Rural Affairs

Securing the future availability and affordability of home insurance in areas of flood risk

June 2013

This document/publication is also available on our website at:

https://consult.defra.gov.uk/flooding/floodinsurance

Any enquiries regarding this document/publication should be sent to us at:

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Topic of this consultation:	A consultation seeking views on the Government's proposals for securing the availability and affordability of flood insurance in areas of flood risk.
Intended audience:	Anyone may reply to this consultation. Specific groups that may have a particular interest include people living in areas of flood risk, local authorities, insurance industry representative bodies, individual insurers and brokers, the property sector, mortgage lenders and those with an interest in flood risk management including flood risk mapping and modelling service providers and flood protection product manufacturers. It also has wider relevance for taxpayers and the general public.
National coverage:	UK wide
Duration	The consultation will run from 27 June to 8 August 2013.
Enquiries	For general enquiries regarding this consultation please contact: floodinsurance@defra.gsi.gov.uk or 020 7238 6239 Or you can write to: Flood Insurance Consultation Department for Environment, Food and Rural Affairs 3rd Floor, Zone C, Nobel House 17 Smith Square, SW1P 3JR
How to respond	Please respond to the consultation using the online survey tool. This is the easiest way to respond. https://consult.defra.gov.uk/flooding/floodinsurance
Body responsible for the consultation	Defra's Flood and Coastal Erosion Risk Management team is responsible for this consultation on behalf of the UK Government.
After the consultation	Following consideration of the responses to this consultation, the Government intends to introduce the relevant measures through the Water Bill.
Impact assessment	A consultation stage impact assessment is available on our website at: https://consult.defra.gov.uk/flooding/floodinsurance

Contents

Foreword by the Secretary of State

This consultation seeks views on the Government's proposals for ensuring that domestic property insurance continues to be widely available and affordable in areas of flood risk in the UK. I with ministerial colleagues intend to seek powers to address this issue through the Water Bill, which was introduced to Parliament and published today. Your views will help develop the final proposals to be put to Parliament later this year.

The UK has a multi-billion pound, world-leading, insurance industry. Insurance cover for flooding is included as a standard part of buildings and contents policies which helps people manage the potential financial consequences of their home being flooded. Mortgage lenders in the UK generally require mortgage holders to purchase buildings insurance which includes cover for flooding.

A series of agreements on flood insurance have been made between Governments in the UK and the insurance industry since the 1960s. The current "Statement of Principles" agreements, which are about to expire, require members of the Association of British Insurers (ABI) to make insurance including cover for flooding available to some, but not all, properties in areas at significant flood risk. The Statement of Principles does not control or limit the price that insurers can charge for this cover.

The insurance market is changing in a number of ways including as a result of more sophisticated flood risk models becoming available. Households in flood risk areas are more likely than in the past to be charged a premium that reflects their risk of making a claim. While in the long-term this will help build greater awareness of flood risk, and encourage appropriate steps to be taken to reduce the risk of flooding, in the shorter term many households may struggle to afford ongoing cover. Householders could face further anxiety if they are unable to meet the conditions of their mortgage or find it difficult to sell their home because of insurance problems. This could also create instability in the housing market in some areas. If flooding were to take place, such households could be left in financial hardship, placing additional pressure on community support services and the State. Therefore the Government intends to provide time-limited, transitional support to households at high flood risk to allow time for choices to be made and risk management action to be taken. Such an approach would be a step-change better than the Statement of Principles it will replace. It would for the first time take steps to secure the affordability as well as the availability of flood insurance.

In the long-term, managing the risk of flooding will always be the best way of securing available and affordable flood insurance. In England, £2.3 billion will be spent during the current spending period to protect households and businesses against flooding. At least 165,000 households will be better protected against flooding in 2015 than they were in 2011. Despite the over-riding need to pay down the deficit, tackling flood risk while avoiding inappropriate new development on flood plains remains at the top of the Government's priorities.

Four broad ways to address the availability and affordability of flood insurance have been considered. There are no easy options to deliver affordable flood insurance and all involve a degree of cost. However, following extensive discussions the Government has reached a headline agreement with the Association of British Insurers on a proposed way forward. This will focus on delivering the ABI's proposed "Flood Re" reinsurance pool for high risk households. A Memorandum of Understanding on Flood Re is being published alongside this consultation, with further details provided in this document. I would welcome your views on Flood Re as the leading proposal at this stage.

There remain a number of aspects of Flood Re that need to be agreed with Parliament, the industry and the European Commission. For this reason, the Government also intends to use the Water Bill to seek powers to allow us to regulate the industry to deliver affordable flood insurance should Flood Re prove unworkable or fail to achieve our goals. Your views on this alternative option are also invited, including in relation to how it might work if it were to be needed.

This is a difficult issue to resolve, as the industry itself recognises. No country in the world has a perfect system. This Government nevertheless is committed to finding a sustainable approach that balances the needs of high risk households, wider policyholders and the taxpayer. We want to ensure that households can continue to access insurance at an affordable price. We want to protect wider billpayers and the taxpayer, creating the conditions for a fair and gradual transition towards more risk-reflective pricing in time. We believe our proposals will achieve this.

I would welcome your views on the proposed way forward set out in this consultation.

RT HON OWEN PATERSON MP

1. Introduction

This consultation is seeking views on the Government's proposals for ensuring that home insurance continues to be widely available and affordable in areas of flood risk.

For the purposes of this consultation the terms 'home insurance' or 'domestic property insurance' are used throughout this document to refer to buildings and contents insurance policies (or combined policies) purchased by those living in permanent, domestic dwellings.

The term 'area of flood risk' is used to refer to land in the UK within the natural flood plain that could be affected in the event of flooding from rivers or the sea, as well as land which is susceptible to flooding from other sources including surface water.

Geographical extent

Financial services including insurance are reserved matters for the purposes of the devolution settlements in Wales, Scotland, and Northern Ireland, as such, they fall within the legislative competence of the UK Government. The territorial extent of this consultation is therefore UK-wide.

2: Background

Flood risk in the UK

In the UK, 5.8 million properties (around 20%) are estimated to be at some risk of flooding. Flood risk management is a devolved competency and Government agencies in England, Wales, Scotland and Northern Ireland make their own assessments of the numbers of properties in areas of flood risk within their own jurisdictions.

There is an inherent uncertainty in flood risk since it is a combination of the likelihood of particular weather and/or sea conditions occurring and the scale of the potential impacts. Both can be influenced significantly by factors as varied as ground saturation, autumn leaf-fall or litter blocking gullies and the condition of any flood defences. Understanding of flood risk from rivers and the sea is much more advanced than for local sources of flood risk such as surface water where for example sometimes unknown local drainage capacity can significantly affect an area's flood risk.

England

In England around 2.4 million properties are at risk of flooding from rivers or the sea[1]. There are also an estimated 3.8 million properties susceptible to surface water flooding, with around one million of these also at risk of flooding from rivers or the sea. Of the 2.4 million at risk from rivers and the sea, around 1.85 million are residential properties. Overall, one in six properties in England are thought to be at some level of flood risk.

Wales

In Wales around 208,000 properties are at risk from flooding from rivers or the sea, of which around 148,000 are residential properties and 60,000 are non-residential properties[2].

In addition there are around 230,000 properties at risk from surface water flooding in Wales although the majority of these are thought to be also at risk from other sources of flooding[3].

Scotland

In Scotland around 125,000 properties are at risk from flooding from rivers and the sea or surface water, of which around 110,000 are residential properties and the remainder are

[1] Environment Agency National Flood Risk Assessment, March 2013
[2] National Flood Risk Assessment (2013)
[3] Flooding in Wales, 2009

non-residential properties[4]. This represents around one in 22 homes and one in 13 businesses in Scotland.

Northern Ireland

In Northern Ireland around 46,000 properties[5] are estimated to be at risk of flooding from rivers and the sea, with an annual likelihood of flooding of 1% or greater (from rivers) or 0.5% or greater (from the sea).

The 46,000 properties at flood risk from rivers and the sea represent around 5% of all properties in Northern Ireland. Three quarters of these properties are residential properties and around a third of the properties at risk are protected to some extent by flood defences or other measures.

Around 20,000 properties in Northern Ireland are located in areas at risk of surface water flooding[6] however many of these properties are also at risk of flooding from flooding from rivers or the sea.

Insurance in the UK

Insurance plays an important role in helping people manage the potential financial consequences of their property being flooded.

The UK has benefited from a private insurance system for flood risk that has existed for more than half a century. Insurance cover for flooding is usually included as a standard part of buildings and contents policies for households alongside other perils such as fire, subsidence and theft.

Mortgage lenders in the UK require home owners to purchase buildings insurance which includes cover for flooding and other perils for the property which is being lent against. They must continue to hold this cover for the duration of the mortgage to comply with the terms of their mortgage. The take-up rate for buildings insurance is 91% for owner-occupiers in the UK although only 29% of the lowest income households have buildings insurance reflecting lower home ownership rates in this income group[7].

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[4] Scottish Environment Protection Agency (2011) The National Flood Risk Assessment. December 2011 December 2011

[5] Rivers Agency (2011) Preliminary Flood Risk Assessment and Methodology for the Identification of Significant Flood Risk Areas

[6] To a depth greater than 300mm from a rainfall event with a 0.5% annual probability

[7] ABI, Household Expenditure on Insurance (2012, based on the 2010 ONS Living Costs and Food Survey) Available at www.abi.org.uk/Insurance-and-savings/Industry-data/~/media/BDAD077EA9624B5BA68FA8B01E8D9D5C.ashx

Contents insurance is not usually required as part of the terms of a mortgage. Take-up of contents insurance varies from 44% of the lowest income households to 90% of highest income households[8].

The price of insurance can vary considerably between households for a variety of reasons. Buildings polices tend to be more expensive than contents because of the higher sums insured and size of potential claims. As well as being more likely to be insured, more affluent households tend to pay more for insurance because of the higher sums insured and their willingness to pay for added features. Currently, the price paid for buildings policies averages £211 and for contents £174[9]. Purchasing a combined buildings and contents policy usually saves money, with an average price paid at present of £363[10]. Purchasing policies online can also help secure additional discounts, reflecting the lower transaction costs for insurers.

The Statement of Principles agreements

A series of agreements on flood insurance have been made between Government and the insurance industry since the 1960s. These started with what is referred to as the “Gentleman’s Agreement”, more recently named the *Statement of Principles on the provision of flood insurance*.

The Association of British Insurers (ABI) represents around 300 insurance companies who together sell around 90% of all insurance products in the UK. In 2008 the previous UK Government and the ABI agreed to revise and extend the Statement of Principles for one last five year period[11]. The ABI entered into similar agreements with the Devolved Administrations in Wales, Scotland and Northern Ireland in 2008 and 2009. These describe the commitments made by Government and ABI members to ensure flood insurance would continue to be widely available.

Under the Statement of Principles, ABI member companies commit to make insurance available to domestic and small business properties[12] in areas that are not at a significant risk of flooding (defined as being at no worse than a 1.3% annual probability of flooding). For properties in significant flood risk areas ABI members agree to continue to offer cover to existing customers if plans are in place to reduce the risk within five years (for example by new or improved flood defences being built). Properties built after 1 January 2009 are not covered by the Statement of Principles, to encourage new development to be built away from flood risk areas.

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[8] *Ibid*
[9] *Ibid*
[10] *Ibid*
[11] ABI / UK Government Revised Statement of Principles on the provision of flood insurance, July 2008
[12] The agreements do not define what a small business is although in general usage, small and medium enterprises are considered to employ 250 or fewer full-time equivalent employees, and within this, ‘small’ enterprises are considered to have 49 or fewer employees.

As such the agreement does not guarantee the universal availability of flood insurance. In addition, the Statement of Principles agreements have not applied to all insurance companies. Insurance companies who are not members of the ABI or have entered the household insurance market subsequent to the agreements being signed in 2008 are not obliged to offer cover at all. The ABI have stated publically that, "The SoP was only ever meant to be a temporary 'sticking plaster'" and that "New entrants to the home insurance market start from a position where they have no commitments under the agreement. This gives them a significant commercial advantage."[13] The Statement of Principles also neither controls nor limits the prices that insurers can charge customers for flood insurance – the agreement states that "the premiums charged and policy terms will reflect the level of risk presented and are not affected by this commitment".

The Statement of Principles renewed in 2008 was expected to be the last. The previous UK Government agreed that by June 2013 "the conditions should be in place to enable the insurance market to be able to provide flood insurance to the vast majority of households and small businesses efficiently without the specific commitments [made by either ABI members or Government]"[14].

The Statement of Principles agreement will formally expire on 30 June 2013. However, on 16 May 2013 the ABI announced that their members would continue to abide by their commitments under the Statement of Principles for a further month in order to allow time for a new approach to be agreed with the Government[15].

The problem under consideration

The insurance market is changing in a number of ways which together could lead to some households in flood risk areas finding home insurance less available or affordable than in the past. This is due to a number of factors that have been emerging for some time, and which are set out below.

Why the market is changing

In the past, households at differing levels of flood risk have largely paid the same for flood insurance. This historical pricing strategy, adopted by insurers voluntarily, means that policyholders at low or no flood risk have in effect been subsidising the cost of policies in higher flood risk areas through their premiums. The exact size of the cross-subsidy on flood insurance is difficult to establish, though it has been estimated by the ABI to be

[13] ABI (2013), written evidence to the Environment, Food and Rural Affairs Select Committee inquiry into flood funding. Available at:
http://www.publications.parliament.uk/pa/cm201213/cmselect/cmenvfru/writev/flood/m07.htm
[14] *Ibid*
[15] See:
www.abi.org.uk/~/media/Files/Documents/Publications/Public/Migrated/Flooding/The%20Future%20of%20Flood%20Insurance.ashx

around £150 million per year for the ~250,000 insured households in the UK at significant flood risk. Customers at lower, though still material levels of flood risk, will also have been cross-subsidised. If a £150 million cross-subsidy was paid for equally by all low risk policyholders it would be equivalent to around £4-5 on average per household buildings and contents policy, or around £8-9 per combined policy.

Whilst some insurance companies use postcodes or proximity to a watercourse to determine the risk of flooding to a property, others use more complex flood risk models alongside data such as a policyholder's claims history. Commercial pressures and the availability of more sophisticated flood risk models are creating a trend towards insurers increasingly assessing local flood risk and imposing at least partially risk-reflective terms. Risk-reflective premiums are typical in mature and competitive insurance markets. According to ABI research[16], 22% of policyholders in areas of significant flood risk were already paying a premium which is reflective of their flood risk by January 2011.

How the market might change in the future

It is difficult to predict what the home insurance market might look like today and in the future if the Statement of Principles or alternative measures were not in place. Flood risk models are becoming increasingly robust and available, both to insurers and the public. These can be used to differentiate between higher and lower risk customers and charge an appropriate risk-reflective premium. In some cases flood models may determine whether insurance is offered at all.

In general, a move towards risk-reflective prices in the longer term, if based on robust flood risk data, would be helpful to reinforce the right incentives for public bodies, businesses, communities and individuals to manage flood risk. This could be through appropriate controls on spatial planning, building and maintaining flood defences and other resilience measures, individual action to protect properties and limit damages, and encouraging flood resistant and resilient property design. In contrast, a situation where there is no difference in insurance costs for high and low risk customers would limit any incentive for even simple and very cost-effective steps to be taken to avoid flood damages.

In the long-term, risk-reflective insurance pricing would therefore seem appropriate if it is introduced at a pace that allows those affected to adjust, choices to be made, and appropriate steps to be taken by those at most risk.

Worst potential impacts of a free market

Analysis summarised as part of our Impact Assessment suggests that even in the worst case scenario, almost all high risk households should continue to find home insurance available to them in a free market. Very few households are genuinely uninsurable against

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[16] ABI (2011) Under-pricing of the flood element of home insurance for domestic customers at significant risk. Research Brief. January 2011. Available on the ABI website: http://www.abi.org.uk/Publications/54261.pdf

flood risk; the key issue is whether cover is affordable. Even in cases where repeated flooding has taken place, households have been able to continue to access insurance. This may be through specialist brokers and perhaps by taking action to make their homes more resilient to flooding. In some instances, insurers have imposed conditions such as requiring property level protection measures to be fitted to limit the potential for future claims. In Germany, where there is no obligation on insurers to offer flood insurance, households are generally able to access flood insurance providing the annual chance of making a flood claim is less than 10%.

If there were to be an *immediate* transition to *fully* risk-reflective prices in a free market, analysis summarised in the Impact Assessment suggests around 600,000 households in the UK might experience at least some increase in their insurance at the point of next renewal. Around 200,000 households in this worst-case scenario may see price rises impact their household income by 2% or more. Taking into account household income, and potential abilities and willingness to pay across the spectrum, around 40,000 high risk households may be forced or priced out of the market in a worst case scenario.

In summary, while a gradual move to risk-reflective pricing in the longer-term would create additional incentives to reduce the likelihood and the cost of flooding, the pace at which this transition takes place would be key. If there was an immediate move to risk-reflective pricing, large numbers of households could see prices rise suddenly and tens of thousands of households could as a result become uninsured.

The commercial property insurance market

Small businesses tend to use a variety of property insurance and business protection products that reflect the particular goods or services they supply and their particular vulnerability to different risks. As such, small business insurance policies are much more diverse than domestic household insurance policies. Insurers tend to offer small businesses a bundle of insurance products aimed at their particular type of business, for example pub, retail, and buy-to let insurance policies.

A survey of over 9,000 businesses in England estimated that less than 1% of businesses had experienced difficulty getting property insurance in the last year due to the risk of flooding. No businesses had been refused insurance cover due to the risk of flooding. The results were highly consistent for all sizes of business[17].

[17] The English Business Survey (EBS) collected information on the difficulty of businesses getting insurance due to flood risk during Quarter 1, 2013. The EBS is a survey of workplaces. Business size refers to the number of employees at the workplace. More details on the survey can be found at: https://www.gov.uk/government/organisations/department-for-business-innovation-skills/series/english-business-survey

Furthermore, unpublished research conducted for the ABI suggests that there is no evidence that the same cross-subsidy that has existed in the domestic property insurance market also occurs in the commercial property insurance market.

Small businesses also tend to have greater flexibility in avoiding any increases in the cost of their insurance. Many small businesses do not purchase buildings insurance but rather lease their premises and may be able to renegotiate their terms if insurance costs increase. Others may be able to enter into greater negotiation with their insurer about the cost or terms of their insurance. Other options available to small businesses include moving stock or equipment away from where it might be at risk of being damaged, investing in reducing the risk of water entering buildings, or passing on any increased costs to their customers especially if their competitors face the same increases.

One constraint in identifying which small businesses might be experiencing difficulty with the availability or affordability of insurance is that current flood risk data does not distinguish between different types of non-residential properties. The premises of a small independent shop, a storage yard and the headquarters of a multinational corporation would all be defined as a non-residential property.

In conclusion, at the moment there is not sufficient evidence to justify Government intervention in the market's provision of property insurance cover for small businesses. We will continue to work with stakeholders to review the commercial property insurance market in areas of flood risk and to consider how best to define domestic insurance policies in secondary legislation. We recognise that there are instances where micro-businesses operate from a domestic property and that the boundary between what is a domestic and a commercial property may not always be clear-cut.

Q1. Do you have any evidence of small businesses experiencing difficulty with the availability and affordability of property insurance due to the risk of flooding?

Consultation with interested parties

Flood Summits and Working Groups

During 2010 and 2011 Defra convened two Flood Summits to bring together a range of interested parties to discuss the challenges involved in flood insurance. Three working groups continued the dialogue and published their findings in December 2011[18].

The working groups included representatives of the insurance industry, communities at risk of flooding and other individuals and organisations with expertise in the issues involved.

[18] See: http://www.defra.gov.uk/publications/files/pb13684-flood-risk-insurance.pdf

Working Group 1 identified options for how to manage the financial risk of flooding after the Statement of Principles expires. Working Group 2 identified issues and suggested improvements to ensure that information on flood risk is transparent and available to all. Working Group 3 considered how flood resistance and resilience measures could reduce risk and be better promoted and communicated.

Working Group 1 concluded that the affordability of insurance in flood risk areas is likely to be a bigger problem than its availability. They agreed a set of common principles and tested potential solutions against those principles (whilst noting that trade-offs are likely to be needed between these principles).

Figure 1: Flood Summit keystone principles

1. A shared approach and engagement with local communities is the only way forward
2. Insurance cover for flooding should continue to be widely available
3. Insurance policies should reflect flood risk, including resilience and efforts by individuals to limit their own damage
4. Action by Government, communities, individuals and businesses to reduce flood risk is the best way of keeping insurance terms affordable
5. The take up of affordable insurance by low-income households should be encouraged
6. Information on flood risk should be more transparent and available to all
7. There should be a timely and transparent service for those going through a flood insurance claim
8. The link between planning and flood risk management is recognised

Subsequent discussions

Building on the findings of Working Group 1, Government has continued its discussions with those represented on the working groups through further stakeholder events and individual meetings with many different organisations. These include meetings with representatives:

- of the insurance industry, including individual insurance companies, brokers, reinsurers, industry regulators, actuarial advisers and legal experts
- of local communities at risk of flooding in the UK and consumer bodies
- with expertise in flood mapping, modelling and risk management
- of mortgage lenders and the commercial and domestic property sector

- of small businesses.

In addition the Government has also held regular and very detailed discussions with the ABI throughout 2012 and 2013, to understand their members' views and to analyse the effectiveness of different policy options including their preferred approach, “Flood Re”, a reinsurance pool for high flood risk households.

This consultation focuses on the issue considered by Working Group 1, managing the financial risk of flooding. The findings of Working Groups 2 and 3 have primarily been taken forward by separate pieces of work such as the ‘Flood Risk Report’ template and the ‘Guide to obtaining flood insurance in high risk areas’ which are described elsewhere in this document.

Policy objective

In light of the discussion in this section, Government's objective is to ensure that domestic property insurance continues to be widely available and affordable in areas of flood risk without placing unsustainable costs on wider policyholders or the taxpayer. Over time there should be a gradual transition towards more risk-reflective prices, based on robust evidence of local risk, to increase the incentives for flood risk to be managed whilst allowing time for choices to be made and appropriate action to be taken. The Government envisages this transition taking place over the next 20-25 years.

Q2. Do you agree with the Government's policy objective for flood insurance?

3. What Government is doing already

The potential options to address the policy objective should be considered in the light of what Government has already done, and continues to do to address the availability and affordability of flood insurance.

Investment in flood risk management

Action to reduce flood risk is and will continue to be the best way of keeping insurance affordable into the future. In England, Defra is on course to spend £2.3 billion on flood risk management in the spending period up to March 2015, which will better protect 165,000 households. In addition, the new partnership funding approach has already brought forward up to an additional £148 million of external funding to supplement the Government's £2.3 billion investment.

In Wales the Welsh Government will spend around £180 million in flood and coastal erosion risk management under the current Government between 2011/12 and 2015/16. In addition, over £60 million has been awarded from the European Regional Development Fund and capital funding centrally allocated for investment in infrastructure. This will reduce the risk of flooding and coastal erosion for over 7,000 properties. A National Programme of Investment will clearly set out a method of prioritisation to help the Welsh Government focus investment in the most at-risk communities.

In Scotland over the 2012-2015 spending period the Scottish Government has made £73 million available for large flood risk management projects and made £53 million available to local authorities through the General Capital Grant.

In Northern Ireland approximately £60 million is spent each year on flood risk management. This includes expenditure on the provision, upgrade and maintenance of river and sea flood defences; and drainage infrastructure, such as open watercourses, culverts, storm water systems and road drainage.

Government’s investment in flood risk management for the 2015/16 spending period was set out in the 2013 Spending Round announcement. Further information can be found on the HM Treasury website: www.gov.uk/government/organisations/hm-treasury.

Improving signposting in the domestic property insurance market

In July 2012 the UK Government published a guide to obtaining flood insurance in high risk areas[19] in collaboration with the National Flood Forum, the insurance industry and other partners. The guide explains how people can access appropriate insurance if they are struggling to find suitable cover through the usual routes and what actions they can take to reduce the impact of flooding on their property. Thousands of copies have been distributed and there has been positive feedback on the guide from both flood-affected communities and the insurance industry.

Helping householders manage the impacts of flood risk

Defra has launched a Flood Resilience Community Pathfinder scheme to test innovative ways of managing flood risk at a community level. Projects are being funded across England, each having been developed locally to address local flood risk and resilience issues, including the availability of insurance.

Information and advice is available to households online about what they can do to protect against the damage that flooding can cause, e.g. signing up for free flood warnings, creating personal flood plans, purchasing flood protection products, and taking steps to reduce the damage flood water can cause. For example, see the Environment Agency website at: www.environment-agency.gov.uk/homeandleisure/floods/default.aspx.

Programmes such as Flood Awareness Wales target communities and help residents understand the risks they face and what they should do at times of flood. Recent research on support for communities in Wales has provided the Welsh Government with recommendations to build upon this support.

The Scottish Government funds the Scottish Flood Forum (SFF) to raise awareness of flood risk across Scotland. The independent SFF works directly with communities and businesses to help them understand and reduce their flood risk. It also provides recovery support after flooding events. The SFF helps build community resilience and individual responsibility.

Department of Agriculture and Rural Development Rivers Agency, in its role of Competent Authority for the implementation of the EU Floods Directive, engages with at-risk communities to ensure they are better prepared to deal with future flood events. NI Direct, the official government website for Northern Ireland citizens, provides useful information on additional steps that can be taken to flood prepare a property. The Strategic Flood Map

[19] See: https://www.gov.uk/government/publications/obtaining-flood-insurance-in-high-risk-areas

for Northern Ireland provides information to the public on areas that are considered to be at risk from rivers, the sea and surface water flooding.

A robust approach to new development in areas of flood risk

There are tight controls on new development in areas of flood risk. In England, this is through the National Planning Policy Framework published in March 2012. The Framework expects inappropriate development in areas at risk of flooding to be avoided by directing development away from areas at highest risk, and where development is necessary, making it safe without increasing flood risk elsewhere. In England, the Environment Agency provides advice to local planning authorities on the flood risk associated with new developments. During 2012/13 planning objections were raised by the Environment Agency in relation to a total of 51,625 residential units. Of these, 51,076 (98.9%) were amended in line with the advice given.

Technical guidance on flood risk published alongside the Framework sets out how this policy should be implemented. The review of planning practice guidance led by Lord Taylor of Goss Moor commented that the technical guidance could be merged with updated and streamlined practice guidance. As set out in the 2013 Budget, Government will publish significantly reduced planning guidance, providing much needed simplicity and clarity in line with Lord Taylor's recommendations.

Planning policy set out in Planning Policy Wales, and Technical Advice Note 15, adopts a precautionary approach and seeks to direct new development away from areas of flood risk in the first instance and not increase the risk of flooding elsewhere.

Where development is allowed because the risk, (taking into account an allowance for climate change for the lifetime of the proposed development) is low, the proposed development should be designed to ensure the development is safe even in a 1 in 1000 year scale flood.

In Scotland, Scottish Planning Policy requires planning authorities to take the probability of flooding from all sources into account and the risks involved when preparing development plans and determining planning applications. It states that development which would have a significant probability of being affected by flooding or would increase the probability of flooding elsewhere should not be permitted. The Scottish Government has commenced work on a consolidated Planning Advice Note on flooding, water and drainage. The Planning Advice Note will provide guidance for developers, applicants and planning authorities on approaches to sustainable flood risk management, including the avoidance and reduction of flood risk and is expected to be published later this year.

In Northern Ireland, Planning Policy Statement 15 (Planning and Flood Risk) sets out the Executive's approach to development in areas of flood risk. There is a clear presumption against development in areas at flood risk and advice on this is provided by Rivers Agency during the drafting of Development Plans and when processing certain planning applications. A review of Planning Policy Statement 15 is currently underway to bring it into line with the EU Floods Directive and to update policies related to all sources of flooding.

Helping insurers to take account of actions taken to reduce flood risk when setting prices

The Government has already taken steps to make it easier to reflect flood risk management in premiums by producing a standard ‘Flood Risk Report’ template for recording the flood risk of a property after installation of flood resistance and resilience measures. This is now available from the Environment Agency website[20] for suitably qualified surveyors to complete. The Flood Risk Report should provide insurers with the information they need to incorporate the benefit of resistance and resilience measures into their risk assessment and pricing decisions where appropriate thereby enabling householders to be financially rewarded for the actions they have taken.

In England and Wales, the Environment Agency and Natural Resources Wales can also provide householders with a detailed flood map or a letter setting out the flood risk from rivers and the sea for the area of their property which they can send to prospective insurers. This is called an Insurance Related Report. These are likely to be particularly helpful for householders who have been quoted high premiums due to their postcode or proximity to a source of flooding but where local circumstances (e.g. topography and routing of floodwaters) mean the property may not actually be at a significant risk of flooding. Households in England can request a report from their local Environment Agency area office. Further information can be found at www.environment-agency.gov.uk/homeandleisure/floods/31654.aspx.

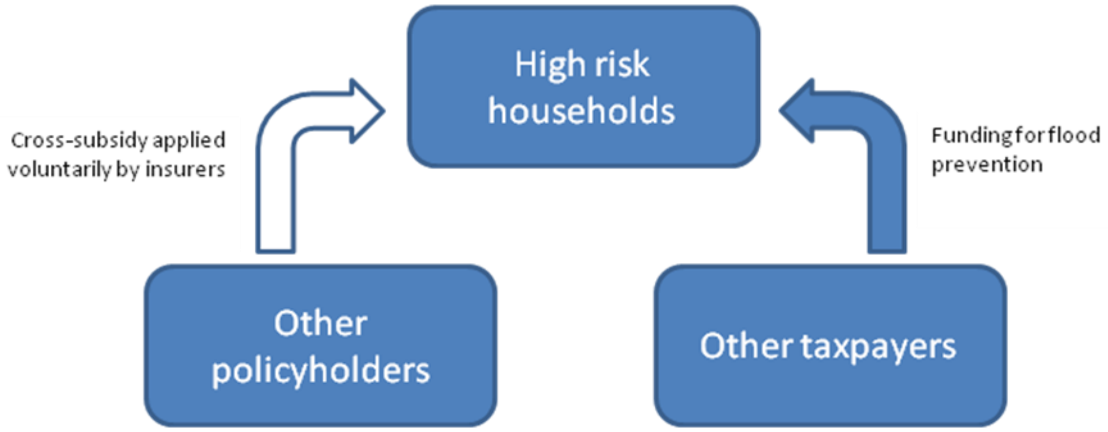
[20] See: http://www.environment-agency.gov.uk/research/planning/129526.aspx

4. Potential solutions considered

In other countries across the world there are many different approaches taken to manage the financial risk of flooding. Annex A sets out the range of approaches that are taken in countries with similar or greater levels of flood risk compared to the UK. It should be noted that none of these approaches prevent flooding from taking place. The decision for national governments is therefore on who should bear the cost of flooding when it happens. There are three main choices: high risk households, other policyholders, and the taxpayer.

As described earlier, high risk households in the UK are in general currently paying less than fully risk-reflective prices for their home insurance. They are therefore benefitting from a cross-subsidy from other policyholders. The taxpayer currently has no formal role in bearing insured losses from flood events. To date the focus of taxpayer funding has been on preventing flooding from occurring in the first place, as this delivers the greatest value for money, although taxpayers also bear some of the costs of flooding when it does occur – for instance in responding to flood incidents, temporary housing costs for some people who have to move out of their homes, and repairing roads and other local infrastructure.

Figure 2: Current support for households at high flood risk



A wide range of potential solutions have been reviewed in considered how best to secure the availability and affordability of flood insurance. Four primary approaches are set out in this section.

An assessment of the cost and benefits of each of these potential solutions has been provided in the accompanying consultation stage Impact Assessment.

Option 1: Market facilitation and focus on flood risk reduction

Summary

Under this approach, the Government would not directly intervene in the market for flood insurance. Domestic property insurance is a competitive and, in general, profitable market, and the vast majority of high risk households would continue to be insurable albeit at higher prices than are typically paid at present. It is therefore possible that if the historic cross-subsidy between low and high risk customers were to unwind further, new market opportunities would emerge for insurers and brokers who specialise in insurance for high flood risk properties.

There are a variety of innovative approaches being developed in the UK domestic insurance market, which are outlined in Figure 3 below. These types of approaches could become more widespread and help with the availability and affordability of flood insurance.

Figure 3: Recent innovations in the provision of insurance in flood risk areas

Using local flood risk information

One insurance broker has used publicly available flood risk information such as Strategic Flood Risk Assessments carried out by local authorities to give them a more detailed understanding of flood risk within an area. Working with local partners the broker has secured insurance for several hundreds of households in the area, at terms described as 'competitive'. The company is considering replicating this approach in other appropriate areas of the country.

There is also the opportunity for the insurance industry to work with property data specialists who licence property databases containing information about the presence of basements, entrance threshold heights and other property features of UK properties.

Such approaches mean that lower risk properties that reside within high risk postcodes or areas can continue to secure competitive terms.

Reinsurance

Reinsurance helps insurers reduce the volatility of their flood claims which can affect their annual profitability. Working through an intermediary, a number of insurers can combine the flood components of all their household insurance policies (both high and low risk) into a pool which is backed by one or more tailored reinsurance policies.

By presenting a single, more diverse portfolio of flood risks to reinsurers, the participating insurers are likely to be offered a better price for reinsurance than if they acted individually. In doing so, individual insurers could save money by having less need for other forms of capital holding (an EU legal requirement). If these savings outweigh the administrative costs of cooperation, participating insurers may be more willing to offer cover to households at flood risk.

Group purchasing

Another intermediary uses bulk buying to achieve group discounts for households seeking buildings and contents insurance which includes cover for flooding. The company works with insurers that want to gain more customers in a particular geographic area.

One of the areas targeted includes households at risk of flooding. Households in this locality, including those at flood risk, are eligible for 12% discounts on the terms that would be offered if they were to approach the insurer individually.

Signposting

More could be done by the insurance industry to assist households who are declined cover due to the risk of flooding to their property. For example the insurance industry has already worked to help older travellers and motorists access insurance more easily through a signposting agreement, developed jointly with Government, in April 2012.

At present some insurers have upper age limits on their motor of travel policies. Now, under the signposting agreement, where a broker or insurer cannot find or provide motor or travel cover due to the customer exceeding upper age limits, they are required to refer the customer to an alternative provider who can meet their needs, or to a dedicated signposting service such as BIBA's 'Find a Broker' service. The signposting agreement has led to 10,000 older people being helped to find motor or travel insurance through the Find a Broker service in the first two months of 2013. By contrast over the same period only around 500 people used the service to find flood insurance.

In addition, insurance companies each take different approaches to pricing so it will almost always pay for households to shop around for an insurance quote regardless of their level of flood risk. One recent survey found that 45% of policyholders did not shop around for their home or motor insurance[21].

For households at no or low flood risk, comparison sites can provide a useful means of quickly gaining automated insurance quotes and comparing different policies. Households at greater risk of flooding will often find it more helpful to speak with different insurers over the phone or use a specialist insurance broker in order to discuss the particular circumstances of their situation and any action they can take to improve the terms of their insurance.

[21] www.telegraph.co.uk/finance/personalfinance/8219024/Always-shopping-around-for-insurance-could-save-policyholders-1.5bn.html

The British Insurance Brokers Association report their members typically find insurance cover for 95% of the households that are usually rejected by mainstream insurers or comparison sites because of the flood risk to their property[22].

Figure 4 below gives three case studies that demonstrate how using a broker has helped households to access affordable insurance where they have not found it possible to obtain such cover through their usual route.

Figure 4: Helping people navigate the insurance industry

Evesham

A property was within an area of significant flood risk and subject to flooding from the River Avon in 2007, resulting in an insurance claim of around £60,000.

The property subsequently benefited from improved protection as a result of a flood defence scheme completed in 2009 and property-level measures (including the installation of non-return valves and demountable flood barriers).

The householder’s existing insurer sought a premium of £2,000 to insure the property but through a broker the householder was subsequently able get cover for £540, subject to them signing up for flood warnings and putting the flood barriers in place when the property is at risk of flooding.

Tiverton

A property lay within an area at flood risk, around 400 metres from the River Exe but it has never been known to have flooded. The previous insurer excluded flood cover from the terms of the insurance, but going through a broker the householder was able to get flood cover included at normal terms with a premium of £394 for buildings and contents.

Willingdon, Derbyshire

A property was located in an area of significant flood risk and situated two metres away from a brook. The prospective purchaser of the property had difficulty finding cover for flooding because the property’s previous owner had made a flood claim. The previous owners arranged for property-level flood protection measures to be installed at the property and had already subscribed to the Environment Agency flood warnings service.

As a result, by going through a broker the new occupant was able to get buildings and contents insurance, including flood cover for £698 on the condition that flood barriers were put in place whenever the property is at risk of flooding. The only exclusion to the policy is that the garage contents are not covered for flooding.

[22] BIBA, evidence to EFRA Committee as part of inquiry into flood funding, 2013.

Under this option we would expect to see the emergence of more insurers and brokers who specialise in insurance for high flood risk properties and who will encourage and reward their customers for adapting their homes to become more flood resilient.

Advantages

Under this option, it is likely that flood insurance would continue to be made available to the vast majority of households, other than those with a history of flood claims or where the likelihood of future flooding is particularly high.

Further action to facilitate the insurance market for high risk households as set out above, and to test innovative new ways of managing flood risk for instance at community level, could also help particularly with the availability of insurance, and potentially also to an extent with the affordability of insurance. Over time more and more specialist insurers and brokers for high flood risk properties could emerge, which could help further with the availability and affordability of insurance.

This option would also ensure that those households most at risk from flooding had an incentive to reduce it, and should be rewarded for doing so through the price of their insurance afterwards.

Unlike all the other options, this option would not require legislation and so could be put in place immediately following the end of the Statement of Principles. In fact, many of the key building blocks of this approach are already in place.

Disadvantages

Although it is likely that insurance would continue to be generally available under this option, the key question for this approach is what impact it would have on the affordability of insurance, and the speed at which the insurance market would transition towards risk-reflective prices. As set out above, this is highly uncertain and would depend critically on how insurers might adapt their pricing strategies within a free market.

If insurers were to move rapidly to risk-reflective prices, or even to cease offering cover at all in some circumstances, this could cause serious difficulties for households at significant flood risk particularly in the shorter-term. Instead, the Government wants to see a gradual transition which allows sufficient time for those affected to take appropriate action.

Option 2: Subsidised reinsurance pool for high flood risk households ("Flood Re")

Summary

This proposal, named "Flood Re" has been put forward as the preferred solution by the ABI on behalf of their members. Insurers would only be able to reinsure policies through Flood Re if they charged households a set price for the flood component of their insurance policy, thereby limiting the potential for price rises. Support would be targeted towards those who need it most and the level of flood insurance excesses would also be controlled.

An industry-run, not-for-profit, scheme would be set up to reinsure policies for UK households at a high risk of flooding. The Flood Re administrator would effectively be a reinsurance company in its own right, and so be regulated by the financial regulators. Household policies eligible to be reinsured by the Flood Re pool would be those whose risk-reflective flood insurance price exceed certain limits ("eligibility thresholds"). Eligibility thresholds would rise over time, initially linked to the consumer price index (CPI), to effect a gradual transition to risk reflective pricing over 20-25 years. They would also differ by council tax valuation bands (or equivalent in Northern Ireland) to target the benefits of the scheme towards lower income households. The most expensive 1% of properties in the UK (e.g. Band H in England) would be excluded to avoid these properties gaining disproportionate benefit at the expense of other households. As with the Statement of Principles, to reinforce planning policy and avoid inappropriate development in flood risk areas, new homes built since January 2009 would also be excluded. Genuinely uninsurable properties would also be excluded.

Where insurance companies could offer cheaper cover than the Flood Re thresholds, they would do so. Customers would be able to shop around to get the best deal. Flood Re would only reinsure those household policies where customers are unable to find an insurance company that is willing to offer a price below the Flood Re thresholds. In this instance, the insurer would pass the flood risk element of the household policy to the Flood Re pool, together with a premium equal to the relevant eligibility threshold. If there were a flood claim on one of these policies, Flood Re would reimburse the insurer for the value of the flood damage claim. If there were any other type of claim on the policy (e.g. fire or theft), the insurer would pay it themselves as normal, without reimbursement from Flood Re. The customer would in all instances manage their policy via the insurer and would not need to contact Flood Re.

By design, Flood Re would on average make a loss on every policy within the pool, as the amount of premium paid to the pool would be less than the insurer's view of the true risk-reflective price. Based on ABI estimates, independently reviewed, Flood Re might reinsure buildings and contents insurance for up to 500,000 UK households based on the industry's proposed eligibility thresholds. Flood Re itself would need to take out its own commercial reinsurance against its exposure to significant damages claims from these policies, as whilst claims over time might average £190 million a year, exceptional flooding could cause claims on Flood Re of up to around £2.5 billion.

In order to adequately fund Flood Re, the ABI has proposed an internal industry levy on insurance companies. Current modelling indicates that this is likely to need to be set at £180 million per year for the first five years. The ABI estimates that this is the same as the value of the existing cross-subsidy in the market for the 500,000 households that may be reinsured by Flood Re[23]. If this estimate is correct, this measure could therefore be introduced without pushing up the price of insurance in general. All insurance companies operating in the household market would be obliged under law to pay the levy.

The levy income would be used to subsidise the lower than risk-reflective insurance prices paid by households reinsured through Flood Re. Together with the premium income it would be used to pay Flood Re's administration and reinsurance costs, and meet any reinsurance claims for policies within the pool below Flood Re's own reinsurance policy threshold. If less than average flooding took place one year, Flood Re would be able to build cash reserves in case there were higher than expected claims in the future. Should Flood Re have insufficient funds to meet the costs of claims before its own reinsurance policy is triggered, insurance companies would need to make ad hoc additional contributions to allow Flood Re to fulfil its obligations to reimburse insurers for their flood claims. Flood Re would only be responsible for meeting claims up to a set annual limit, which would be the same as the upper limit on Flood Re's own reinsurance policy. This upper limit would be set each year at a value that independent actuaries would not expect to be exceeded in 99.5% of years[24]. If this limit were ever to be exceeded, the Government of the day would work with Flood Re and the insurance industry to decide how any available resources should be distributed to households reinsured through Flood Re.

The insurance industry is better placed than Government to run what would be a reinsurance company in its own right operating in the high risk end of the market. As such it is important that Flood Re would be able to benefit from industry expertise and operate as an integral part of the insurance market. Flood Re would be regulated in the same way as any other reinsurance company. Neither Ministers nor their officials would be involved in the day to day running of the company although certain elements, such as the levy value, or Flood Re's impact on the public finances, would need to be agreed with Government. Flood Re would need to be established in such a way that it meets standards for accountability which are acceptable to Parliament. State aid approval would also be required from the European Commission.

Primary legislation would be required to allow insurance companies to be levied, and to establish Flood Re.

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[23] The £150 million figure quoted earlier in this document relates to the existing cross-subsidy for the highest risk 250,000 UK households only.
[24] Or other words, at the 1 in 200 loss scenario for claims in aggregate over the course of a single year.

Advantages

Households at high risk of flooding should always be able to find insurance cover, with the flood component offered at a price that is no higher than the Flood Re eligibility threshold (plus overheads). This should help ensure the future availability of flood insurance, and so provide certainty and peace of mind to high risk households.

Setting eligibility thresholds for entry to Flood Re would limit the potential for price increases that might otherwise take place, ensuring that insurance should always be available, and at a price which is reasonably affordable.

Linking the eligibility thresholds to council tax valuation bands (or equivalents) would help target the scheme towards lower income households, to further help with affordability.

The ABI estimate that the costs of the levy would mirror the existing cross-subsidy between policyholders at low and high risk of flooding. If this estimate is correct, this means the levy could be introduced without placing pressure on bills in general.

Flood Re would also benefit from being set up and run by the industry, which has the required expertise.

Another advantage is that the customer experience of households purchasing insurance would remain virtually unchanged since customers seeking a quote or making a claim would continue to conduct all their transactions with the insurer of their choice.

It would take time before Flood Re could be fully operational. However, Flood Re has the support of the industry and they have agreed in this scenario that they would continue to abide by their commitments under the 2008 Statement of Principles until Flood Re is up and running (likely to be mid 2015). This would help ensure a smooth transition, and minimise disruption for householders at risk of flooding in the period before Flood Re is operational.

Disadvantages

Some households at risk of flooding might still not be able to afford flood insurance even with the prices set by Flood Re, and varied by council tax bands so that support is focused towards lower-income households. However, if Flood Re's eligibility thresholds were to be reduced it would require a higher levy to be paid by insurance companies. This would feed through into increased bills in general.

According to the ABI, Flood Re's own reinsurance policy is expected to cost in the region of £165 million. The price of reinsurance can fluctuate in response to events around the world, and the costs would need to be met by the levy on insurers. As the levy would be fixed at £180 million for the first five years, it may be beneficial to negotiate a multi-year reinsurance agreement to ensure the cost of reinsurance does not exceed the levy income. If reinsurance costs were higher than expected, it would increase the likelihood of Flood Re needing extra funding from insurers.

Initial analysis suggests that Flood Re would reinsure over half of UK residential flood losses (by value). Evidence provided so far suggests that individual insurers' own reinsurance costs would not decrease significantly as policies are ceded to Flood Re. This is because insurers' standard reinsurance treaties will cover potential losses from other perils (as well as flooding) such as windstorm, which has a large bearing on the prices paid by insurers for such contracts. The implication of this is that the economic costs of Flood Re, including the reinsurance contract, are expected to be greater than the economic benefits Flood Re delivers, as far as they can be quantified. This means strictly speaking, Flood Re does not achieve the level of value for money normally required of Government policies. As set out in the accompanying Impact Assessment it has not been possible to attach values to some of the costs and benefits of any Government intervention, including in relation to any changes in the take-up of insurance for non-flood perils, and any adverse effects resulting from uncertainty about the future availability of affordable floods cover. In addition, Flood Re has some advantages which other policy options would not provide. However, if our broad analysis of Flood Re's value for money remains unchanged, a Ministerial Direction would be required before moving ahead with the implementation of Flood Re.

The Flood Re eligibility thresholds are based on price alone. Other things being equal, households with a 1% or 10% annual chance of making a claim will pay the same price for insurance under Flood Re. This will somewhat weaken the incentives for individual households to take appropriate steps to manage their risk of flooding.

The income from the levy on insurance policies used to fund the pool is likely to count as State aid to Flood Re's participating insurance companies and potentially to Flood Re itself. This would require the Government to seek approval from the European Commission, a process that can take between eighteen and twenty four months. The Commission may consider the approach or level of aid involved unacceptable, and require changes to be made to Flood Re's design that render the proposal unacceptable to the industry, or to Government.

Option 3: Directly subsidising insurance premiums

Summary

This option would also involve an internal industry levy on household insurers in the UK. Instead of funding a separate reinsurance pool for high-risk households as under Flood Re, the income from the levy would be used to directly reduce the insurance premiums paid by those at highest flood risk. Insurers would continue to price polices and provide all the other aspects of insurance as they do currently. The subsidy could either be channelled through insurers or paid directly to households for example in the form of an insurance discount "voucher" which insurers could redeem from the Government or possibly from local authorities.

Theoretically, support could be made available to anyone receiving an insurance quote over a certain level. However this could provide perverse incentives for insurers to charge high prices and customers to not shop around. To avoid this, a Government-administered register of high risk flood households would be required to identify those eligible for subsidised insurance. An actuarial flood risk model could be developed or purchased to determine the appropriate level of subsidy for different households on the list, based for instance on their flood risk and cost of insurance.

Alternatively all households on the register could be given the same level of discount – this would be simpler but would represent less tailored support.

Legislation would be required to establish a new levy on insurers.

Advantages

This option would provide a degree of certainty to households on the level of support they can expect to receive, and support could be delivered directly to policyholders, for example through local authorities.

Analysis suggests that for a given amount of cross-subsidy imposed through the levy, the prices paid by households at risk of flooding would on average be lower than under Flood Re. This is because the levy would not need to pay for the additional reinsurance costs of a separate pool for high risk households. Instead, insurers would rely on their existing reinsurance contracts. As a result, the analysis also suggests that the benefits of this option exceed its costs.

Since this approach involves offering a discount on insurance premiums that are likely to remain at least somewhat risk-reflective, this proposal retains some of the incentives on individual households to act to reduce the risk of needing to make a claim. It would therefore also encourage further market innovation to develop products aimed at high-risk customers.

Although this option would require legislation, it could be implemented more quickly than either Flood Re (option 2) or the Obligation (option 4).

Disadvantages

This approach would lead to some improvements in the availability and affordability of insurance in flood risk areas but its impact would be uncertain. This will depend on whether insurers are willing to underwrite high risk households, even taking account of the subsidies on offer. The effectiveness of this option also heavily depends on whether insurers agree with the assessment of flood risk in the register of high-risk households, which is by no means certain as insurers will make pricing decisions partly based on data that Government has no access to, such as claims history. In addition, as the prices would be discounted rather than set at a specified level (as under Flood Re), there would be no certainty for households at risk of flooding about the likely price they would need to pay for insurance.

Providing the same level of subsidy to all high-risk households would mean that in many cases the subsidies would be unnecessarily high, leading to a poor use of public funds, or too low, and therefore not leading to affordable insurance.

If the subsidy was to be given directly to insurers (rather than customers) there would be scope for insurers to take advantage of the system and not pass the full benefit of the subsidy on to high risk households. However, if subsidies were paid to customers directly, this would be administratively complex and costly, and would require individual households to proactively claim the subsidy they were due which might lead to lower take-up.

The public funds involved in subsidising insurance premiums would potentially count as State aid, especially if channelled through insurers, and approval would need to be sought from the European Commission. This could delay the implementation of this approach by between eighteen and twenty-four months and, as with Flood Re, the Commission might insist upon certain undesirable changes.

This option would take some time to implement, although it would be quicker than other options. As it is not supported by the insurance industry, there therefore might not be a smooth transition during the interim period between the end of the current Statement of Principles and the start of any subsidy scheme.

Option 4: A Flood Insurance Obligation

Summary

This option would involve regulating for the availability of affordable home insurance in flood risk areas through the introduction of a Flood Insurance Obligation. All insurance companies writing domestic property insurance policies in the UK would be required to insure a certain proportion of households at high risk of flooding, or face enforcement action.

This would help with the affordability of flood insurance since sufficiently attractive terms would need to be offered to high risk households for insurers to win enough business to meet their obligation and avoid enforcement action. The system of quotas for insurance companies would also address insurance availability, depending on the level at which the obligation were set. Customers would be able to shop around to get the best deal, to find an insurer willing to offer a discount, or that has a relatively low risk assessment for their property in the first place.

As with the direct subsidy proposal, a register of high flood risk households would be required. There would be procedures to allow misclassified households to opt in or out of the register and for appeals against any decisions on inclusion or exclusion from the register to be made and settled. It is estimated that, if the register included all UK houses at a 1% annual chance or greater of flooding from rivers or the sea, around 500,000 properties would be covered by the Obligation. This is similar to the number of households we might expect to be within the scope of Flood Re.

The Government would set an obligation target; the minimum number of high risk households within the group that need to be insured at any point in time. This would be less than 100% as not all households want insurance; the target would take account of existing levels of take-up and likely demand. Each insurer's share of the target would be determined by their share of the UK home insurance market, defined for example by their gross written premium. It might also be possible to exempt some insurers from the obligation e.g. those below a *de minimis* threshold.

A regulator would supervise compliance with the obligation and consider enforcement action in the event of non-compliance.

As with Flood Re, legislation would be required, in this case to give Government the powers to introduce the Flood Insurance Obligation and the accompanying supervision and enforcement requirements.

Advantages

As set out in the Impact Assessment, and depending on the level of the obligation target set by Government, the prices likely to be paid by households at high flood risk under an obligation would on average be lower than under Flood Re (option 2) and comparable to the prices paid under the subsidies option (option 3) for a comparable amount of cross-subsidy between households.

Initial economic modelling suggests that, as for the subsidies option, an obligation would tend to lead to households being offered a fixed value discount on the risk-based price insurers would like to charge. The level of discounting would be greater if a more stretching obligation target is set (i.e. if insurers need to provide cover to more high-risk households). Fixed value discounting (rather than set prices as under Flood Re) would mean a greater element of risk-reflective pricing would remain for high-risk households, encouraging those most at risk to take appropriate action to reduce the potential for future claims, and the market to innovate to develop products aimed at supporting higher risk customers.

As with the Flood Re option, the obligation would create a level playing field, with all insurers required to participate on the same basis.

Overall, our analysis suggests that at this stage that the benefits of introducing an obligation would outweigh its costs.

As for Flood Re, the customer experience of households purchasing insurance would remain virtually unchanged since customers seeking a quote or making a claim would continue to conduct all their transactions with the insurer of their choice.

The obligation scheme would not count as State Aid and therefore the Government would not need to notify the European Commission before its introduction.

Disadvantages

This option constitutes a significant intervention in a complex market and its impact on pricing is more difficult to calculate at this stage than for other options. An obligation would need to be designed carefully to ensure that it had the desired effect.

The obligation relies on a register of households at high flood-risk to determine which households insurers would compete to underwrite in order to meet their obligations. If the register misclassified a household's flood risk this could lead to either unnecessary discounting of premiums (and therefore additional costs for other policyholders) or high-risk households left without the support the obligation would provide. This could be mitigated by allowing households to opt in (on presentation of appropriate evidence) and out of the obligation, but this would rely on proactive action by those households and would add to the costs of administration

The obligation would need to be set at an appropriate level for the scheme to ensure flood insurance continues to be widely available and affordable without placing unsustainable costs on wider policyholders. If the obligation were set too low, high risk households may not benefit from reduced insurance premiums; if the obligation were set too high, insurance companies might be incentivised to provide very cheap insurance for high risk households (reducing their incentives to manage their own flood risk) and correspondingly overpriced insurance for other (lower risk) policyholders, or may decide to no longer offer home insurance in the UK. The impact on insurance prices of introducing the obligation would also depend in part on how insurers choose to react.

This option would take some time to implement. As it is not supported by the insurance industry, there therefore might not be a smooth transition during the interim period between the end of the current Statement of Principles and the Obligation taking effect.

Conclusions

Having analysed these potential solutions we have concluded that neither an unmanaged free market nor directly subsidising insurance premiums would meet the policy objective of ensuring that insurance continues to be widely available and affordable in areas of flood risk without placing unsustainable costs on wider policyholders or the taxpayer. More information on the different options is set out in the accompanying Impact Assessment.

The benefits of directly subsidising premiums are uncertain, as there is the potential for the full benefits not to be passed on to consumers. This could be overcome by providing the subsidy directly to households but this would be administratively complex and costly, and, unlike the other options, would require proactive action by individual households. Its effectiveness would also rely on a correlation between insurers' and Government's assessment of flood risk, something that is by no means certain. Allowing a facilitated free market to emerge has the potential to meet the policy objective, but on its own this is highly uncertain and will depend critically on how insurers respond to the ending of the Statement of Principles.

Both Flood Re and the Flood Insurance Obligation appear to have the potential to meet the policy objective, though each has distinct strengths and weaknesses.

Q3. Do you agree with the approach taken to analysing the different potential solutions in the Impact Assessment?

Q4. Do you agree with the evidence presented in the Impact Assessment?

Q5. Do you have any further evidence which has not been considered in the Impact Assessment?

5. The proposed solution

The Government's preference is to work with the insurance industry to secure the affordability and availability of flood insurance. We have therefore reached a headline agreement on a way forward at this stage based on the ABI's "Flood Re" reinsurance pool for high risk households. A Memorandum of Understanding on Flood Re has been agreed with the ABI, and is available alongside this consultation document.

By being open only to insurers charging set prices, Flood Re would provide relative certainty to high risk households about the future costs of their flood insurance. The ABI estimate that it can be introduced without impacting customer bills in general. It also has the support of the industry which would be preferable and help to ensure a smooth transition in the interim period. However, there are still a number of important issues to resolve with the Flood Re approach, such as securing State Aid approval from the European Commission. Therefore we also propose to also take steps to allow the Flood Insurance Obligation to be implemented if Flood Re proved unworkable at any stage or would not deliver our goals, or if pricing for high risk households under a free market approach proved to be unacceptable. This approach should provide reassurance to those at risk of flooding that the Government will ensure they have access to affordable insurance in the future one way or another.

It will take time before Flood Re could be made operational. Government and the insurance industry will continue to work together to ensure that insurance continues to be widely available and affordable in areas of flood risk in the meantime. The industry has agreed to continue to abide voluntarily by their commitments under the 2008 Statement of Principles in the interim period until such a stage that Flood Re can begin operation. This will provide valuable, immediate reassurance for householders at risk of flooding.

The Government believes that both Flood Re and the Obligation would ensure those at risk of flooding are able to find affordable insurance in the short to medium term. Through further targeting of support in future years, the insurance market will be able to make a gradual transition towards risk reflective pricing in the long term. Whichever policy is finally implemented – Flood Re or the Obligation – it would be transitional and be withdrawn after a 20 to 25 year period.

This approach should provide reassurance to those at risk of flooding that Government will ensure they have access to affordable insurance in future in one way or another, while enabling a longer-term transition towards more risk-reflective prices in line with the policy objectives set out earlier in this consultation document.

Q6. Do you support the Government's proposed approach?

Q7. If the remaining challenges associated with Flood Re prove too difficult to overcome, what factors do you think should be taken into account ahead of any decision on whether or not to introduce the Flood Insurance Obligation?

6. Detailed proposals on Flood Re

We propose to take powers in the Water Bill to enable us to introduce Flood Re. The main powers needed in legislation would be to:

- compel all insurers offering household insurance to participate in Flood Re; and
- provide for Flood Re to be funded through an industry levy and ad hoc contributions.

The Bill will also need to set out the arrangements for Parliamentary accountability. In line with the policy objective of a managed transition to risk reflective insurance prices in the longer-term, we also propose to introduce a 'sunset clause' in the primary legislation which would set an expiry date for Flood Re, as well as powers to ensure an orderly winding down of the scheme.

The following section sets out how we envisage Flood Re working and where we need further evidence and views at this stage. It is based on the Memorandum of Understanding which has been reached between the Government and the ABI, which sets out the key elements of the Flood Re proposal. Alongside this consultation, we will continue to work with the industry to develop the design of Flood Re in greater detail.

Eligibility for Flood Re support

The benefits of Flood Re would be targeted towards those households both at a high risk of flooding and on lower incomes. 'Eligibility thresholds' would determine whether a household could be reinsured by Flood Re. Whether or not a household is eligible would be determined by insurers based on previous claims and any models of local flood risk they may have. The thresholds would be applicable to the flood risk component of the policy only, calculated before insurers' overheads such as administration costs, and profit, are added in.

To help target lower income households in particular, the eligibility thresholds would be lower amongst the lower council tax valuation bands in England, Scotland and Wales, and bandings of rateable values in Northern Ireland. The most expensive 1% of properties (e.g. council tax band H in England) would be excluded from Flood Re. Varying these thresholds by council tax band appears to be the simplest way of targeting benefits towards those on lower incomes without incurring significant extra administration costs.

Table 1: Flood Re eligibility thresholds for the 'technical' (net) price of flood cover

Council Tax Band	A	B	C	D	E	F	G	H
Contents cover	£ 78	£ 78	£ 98	£ 108	£ 131	£ 148	£ 206	No cap/not eligible
Buildings cover	£ 132	£ 132	£ 148	£ 168	£ 199	£ 260	£ 334	
Combined cover	£ 210	£ 210	£ 246	£ 276	£ 330	£ 408	£ 540	

The graduated thresholds would help ensure that lower prices were available to lower income households based on council tax bandings, so that support is targeted towards those households who needed it most. Without such targeting most of the support provided by Flood Re would go to wealthier households who tend to live in higher value properties with more expensive insurance premiums even before flood risk is taken in to account.

On top of the above prices, households would typically pay an amount to cover fire, theft and other relevant perils alongside flood, and an amount to cover the insurer's overheads and profit. The following table sets out how much households may on average pay for a policy overall, once these additional costs are factored in. Overheads can typically add two-thirds to the technical risk prices charged by insurers[25].

Table 2: Expected approximate end prices to high risk policyholders for a combined buildings and contents policy, including other perils, assuming overheads/profit add 66% to net prices

Council Tax Band	A	B	C	D	E	F	G	H
Technical flood component charged by Flood Re	£ 210	£ 210	£ 246	£ 276	£ 330	£ 408	£ 540	No cap/not eligible
Other perils (fire, theft, etc)	£ 180	£ 180	£ 186	£ 204	£ 222	£ 252	£ 390	“”
Insurer overheads, profit	£ 260	£ 260	£ 288	£ 320	£ 368	£ 440	£ 620	“”
End price to policyholder, gross, all perils	**£ 650**	**£ 650**	**£ 720**	**£ 800**	**£ 920**	**£ 1,100**	**£ 1,550**	“”
Compared to fully risk-reflective prices, gross, all perils[26]	£ 1,140	£ 1,165	£ 1,185	£ 1,290	£ 1,430	£ 1,560	£ 1,850	“”

The eligibility thresholds would increase over time, initially by the Consumer Price Index (CPI), to effect a gradual transition to risk reflective pricing over the 20-25 years that Flood Re would be in operation.

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[25] ABI, unpublished.
[26] See impact assessment. These are the average prices that might become charged within a free market if insurers were to charge high risk customers fully risk-reflective prices.

Other exclusions

Tighter controls on development in areas of flood risk were introduced as part of Planning Policy Statement 25, and subsequently with the National Planning Policy Framework. To reinforce planning policy, and avoid inappropriate development in flood risk areas the Statement of Principles excludes new development since January 2009. It is proposed that new homes built after January 2009 would similarly be excluded from the Flood Re pool.

It is also possible to envisage other exclusions from eligibility for Flood Re. For instance, there may be an argument that properties at extremely high risk of flooding (e.g. where flood damages are expected every year or two) should be excluded from Flood Re. These properties are likely to have been unable to find insurance for some time. Their very high likelihood of flooding may mean flooding within a reasonably short period is almost inevitable rather than a distant risk. Insurance is not appropriate nor cost effective where events are expected. Including such properties would increase the expected cost of claims, and require a larger levy on insurers (at the expense of wider policyholders). If these properties are to be excluded, we would need to consider whether and how these could be identified, and whether for instance installing property-level protection measures would allow their entry into Flood Re.

Types of policies

Buildings cover is a requirement of any mortgage agreement and prices are more sensitive to levels of local flood risk than for contents cover due to the higher average claim costs involved (£40,000 for an average buildings flood claim in comparison to £15,000 for an average contents claim[27]). Flood warnings can also reduce the amount of damage to householders' belongings during a flooding event. It would therefore be a priority to ensure householders have access to buildings insurance. However, limiting Flood Re support to buildings cover only policies would mean no direct support for social or private tenants in rented accommodation. We therefore propose that both buildings and contents cover would be supported by Flood Re.

Q8. Do you agree that setting the eligibility thresholds according to council tax bands (or their equivalents in the Devolved Administrations) will help ensure Flood Re support is targeted towards those households who need it most, without requiring significant administration? Is there a better method?

Q9. Do you have any views on the proposed initial "eligibility thresholds" within Flood Re (table 1 above), which would effectively cap the technical flood risk premium paid by high risk households?

Q10. Do you agree that the following should be excluded from Flood Re:

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[27] ABI, unpublished.

a. Band H properties?

b. New homes built after January 2009?

c. Genuinely uninsurable properties? If so, how would you define these in a consistent way that insurance companies can apply?

Q11. Should other exemptions also apply?

Q12. Do you agree that Flood Re should apply to both buildings and contents insurance?

Managing Flood Re's exposure to large losses

The reinsurance Flood Re would provide to insurers would be limited to the 1 in 200 year loss scenario. This would be the total value of claims from households reinsured through Flood Re that, during the course of a year, actuaries would not expect to be exceeded in 99.5% of years (or in other words, are 99.5% confident that the limit wouldn't be exceeded in any one year). The value of the 1:200 loss scenario would be reviewed each year but is initially expected to be around £2.5 billion. Flood Re would not reimburse insurers for claims from households reinsured through Flood Re beyond this limit in any given year. This is to prevent Flood Re having to meet the costs of a liability above this level, which would require a higher levy to be imposed.

In the event of claims from households reinsured through Flood Re being in excess of Flood Re's limit, the Government would work with Flood Re and the insurance industry to decide how any available resources should be distributed to households reinsured through Flood Re.

Flood Re will also need to purchase reinsurance to cover the potential for large claims in any one year. Claims on Flood Re could be as high as £2.5 billion in a year of very significant flooding. For this scale of claim on Flood Re to occur, overall UK flood damages would have to be £12 billion[28]. The UK has not seen a flood on this scale since 1953, if ever. If reinsurance were not in place a much higher levy would be needed, and Flood Re would have to build up a very large reserve which would take many years.

Q13. Do you have any comments on this proposed way of managing Flood Re's exposure to large losses?

Funding – the annual levy on insurers

The ABI estimate that Flood Re would initially need a levy of £180 million per year to operate, and that this is roughly equivalent to the estimated value of the current cross

[28] Flood Re is expected to underwrite just over half of UK residential flood damages. Residential flood damages typically account for 40% over overall flood damages. So a flood causing £12 billion UK economic damages in total might lead to £2.5 billion in claims on Flood Re.

subsidy between low and high risk households[29]. If these costs are passed on in full, and amongst UK domestic policyholders, this levy would be the equivalent of around £10.50 per UK household with both contents and buildings cover in place.

Flood Re would be funded by the fixed premiums gathered from households to be reinsured through the pool, and the annual levy paid by all insurers. The levy each insurer pays would be based on their share of the UK home insurance market.

The levy rate would be agreed between insurers and the Government of the day, and would initially be set for a five year period. If the levy were to be set at a level above £180 million, it would place additional pressure on bills for all policyholders but would allow Flood Re's eligibility thresholds to be lower providing cheaper insurance for high risk households. On the other hand, whilst a lower levy would reduce any potential impact on wider policyholders it would also reduce the level of support which Flood Re could provide. A lower levy would require the eligibility thresholds to be increased to avoid Flood Re being underfunded, meaning fewer high risk households would be supported, and the prices they pay for insurance would be higher.

If the total income from the levy and from policies placed within Flood Re is not sufficient to meet Flood Re's outgoings, the shortfall would be made up by ad hoc payments from insurers. The amounts extended by each insurer are expected to reflect their market share in domestic property insurance.

Q14. Do you think a levy equating to around £10.50 per UK household, which the ABI estimate is equivalent to the current cross-subsidy, is acceptable to help address the problem of securing affordable flood insurance for high risk households?

Accountability and Governance

Government considers it likely that some of Flood Re's income may be classified as tax and spend by the Office of National Statistics (ONS). This will have implications for Flood Re's accountability for any expenditure, which is likely to be classified as part of public spending. Appropriate accountability and governance arrangements will therefore need to be agreed with Parliament.

Limiting Flood Re's liabilities and ensuring Flood Re itself holds reinsurance would also help limit Flood Re's impact on the public finances, due to Flood Re's expected status as a public body. Flood Re will be owned by the industry and Government will carry no liability for any of its activities. However because its operations are expected to be reflected in the overall public finances, if Flood Re provided unlimited reinsurance to insurers the public finances could theoretically be exposed to a virtually unlimited extent. The Government is continuing to discuss with the insurance industry what other arrangements might be needed to limit Flood Re's impact on the public finances.

[29] ABI, unpublished.

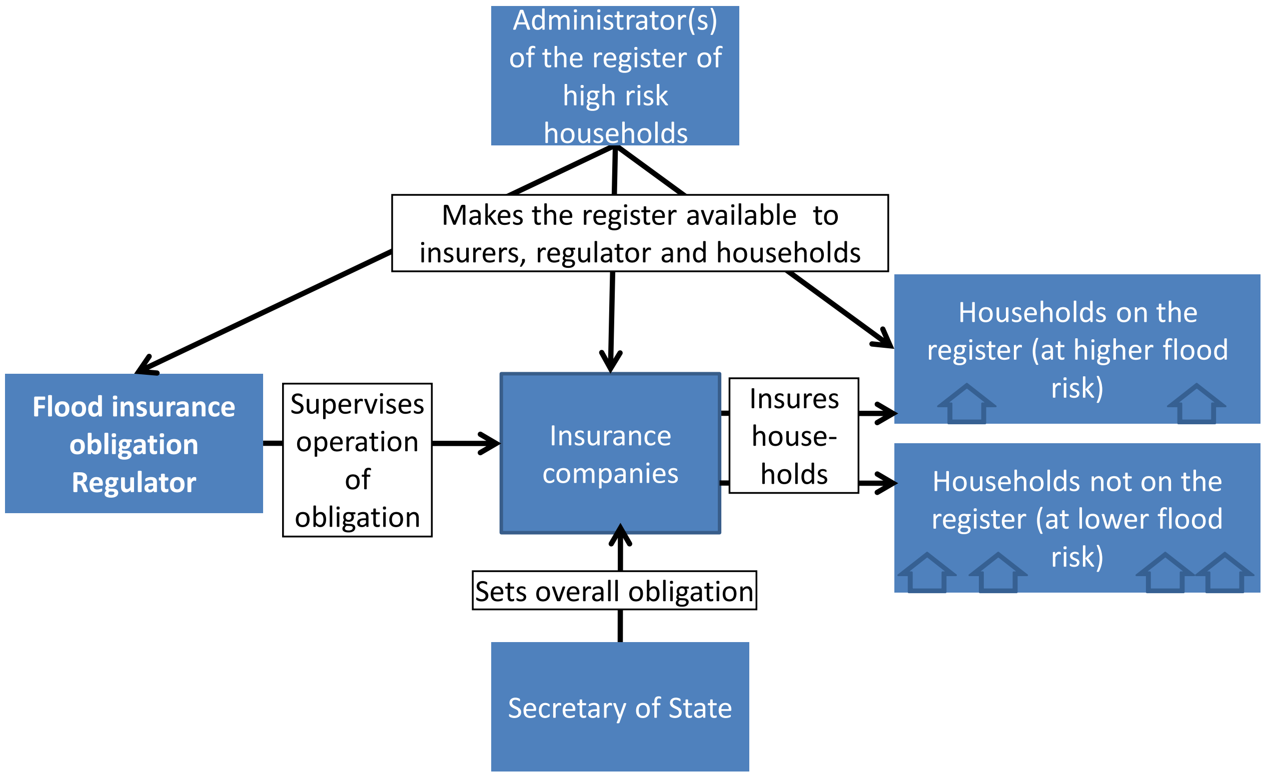
The Government therefore intends to treat Flood Re as a commercial operation, as a reinsurance company in its own right. Through the Water Bill, we will be seeking Parliamentary agreement to how Parliament will oversee Flood Re. The proposal is that the relevant Ministers would be accountable to Parliament concerning general policy matters relating to flood insurance, but not for the detailed income and expenditure or value for money of Flood Re. Instead, as an industry-owned and managed entity, Flood Re itself rather than Ministers would be directly accountable to Parliament on these issues. The Government is aware that these arrangements would offer Parliament less control and less insight into Flood Re's operations than would be available if it were treated as a public sector insurance company. However, the Government is keen to strike a balance between the full requirements of accountability to Parliament, and the need for Flood Re to operate as an integral part of the insurance market.

Q15. Do you agree that Flood Re will secure the availability and affordability of household flood insurance in the UK?

7. Detailed proposals on the Flood Insurance Obligation

We propose to take powers in the Water Bill to enable us to introduce a Flood Insurance Obligation should Flood Re become unworkable at any stage or it not deliver the desired outcomes, and if pricing in a free market proves to be unacceptable. In the absence of Flood Re a free market would inevitably unfold. As described earlier, there is the potential for home insurance to continue to be available for the majority of high risk customers, and market innovation may be able to help with its affordability. However, if it became clear that insurers were unable to exercise price restraint within such a free market Government would be forced to step in and regulate for the availability and affordability of flood insurance. Taking enabling powers in the Water Bill now would provide Government with the ability to introduce more detailed secondary legislation at a later date, should the need arise. There would be further consultation regarding the detail of the approach before any secondary legislation could be introduced which would give effect to the Flood Insurance Obligation.

Figure 5: Actors involved in the obligation scheme



The Government therefore intends to introduce enabling clauses on the Flood Insurance Obligation via an amendment to the Water Bill in the autumn. These provisions would set out in broad terms the nature of the Flood Insurance Obligation. At present the following powers for the Secretary of State and/or other relevant ministers are anticipated:

- A power for the Secretary of State to place an obligation on insurers operating in the UK domestic insurance market to provide insurance cover against flooding to a specified proportion or quota of properties which are at high risk of flooding (the “Flood Insurance Obligation”).

- A power for the Secretary of State to define the number and scope of properties which will be subject to the Flood Insurance Obligation, and the type of insurers which will be subject to the Flood Insurance Obligation.

- A power for the Secretary of State to appoint an administrator(s) of a flood risk register of domestic properties at high risk of flooding

- A power for the relevant minister to introduce a supervisory and enforcement framework that the regulator of the Obligation (to be named in the Bill) would operate.

The nature of the obligation

We propose that the Secretary of State be given the power to place an obligation on all insurance companies writing domestic insurance policies in the UK. The obligation would require insurance companies to insure a proportion of households from a register of high-risk households in the UK, creating a level playing field and overcoming the competitive pressures on insurers to withdraw from flood risk areas. In practice this should mean that all but a minority of households at the highest risk should continue to be able to access flood insurance at an affordable rate, since insurers will have to compete for their business in order to meet their share of the obligation, or face enforcement action for failing to meet their obligations.

The Secretary of State would identify the total number of households that insurers collectively would need to underwrite (the ‘obligation target). This would not cover all properties on the register as not all households want insurance. Certain properties could be excluded e.g. those built after 2009, which are not currently covered by the Statement of Principles. However, this would be the subject of a later consultation.

The Secretary of State would then set out in secondary legislation a formula to determine the proportion of properties on the register that each participating insurer would be required to cover. This formula would be based on market share and could be applied either by the regulator (who would notify firms of their obligation target) or by the firms themselves. If the latter, depending on the complexity of the formula, firms could be required to commission an independent audit to verify their calculation. We anticipate that market share could be defined on the basis of gross written premium in the domestic insurance market; however the details would be set out in secondary legislation.

We also propose that the Secretary of State be given the power to exempt some insurers operating in the UK domestic property insurance market from the obligation, and decide the basis on which this could be done. For example small, specialist insurers below a defined threshold (or ‘de minimis’ limit) could be exempted from the obligation, to help limit the burden on small businesses. A ‘de minimis’ limit would also allow new entrants to gain a foothold in the market, to encourage competition.

These powers would also give the Secretary of State the ability to define in secondary legislation whether, for example, both buildings and contents insurance policies should be counted as part of the obligation and what defines a domestic insurance policy (for example, whether insurance policies covering householders using their home for business purposes should be within scope).

Transitional arrangements

In line with the policy objective of a managed transition to risk-reflective insurance prices, we propose to include a ‘sunset clause’ in the primary legislation which would set an expiry date for the Flood Insurance Obligation. We propose that, if implemented, the obligation should be phased out over the same time period as for Flood Re (20-25 years) thereby giving time for households at high flood risk to make long-term decisions and take appropriate action.

The Secretary of State would therefore review the obligation goal on a regular basis, to manage the transition to risk-reflective prices by reducing the number of properties included in the overall goal. This would also incentivise households to take measures to reduce their level of risk in order to continue to offer an attractive prospect to participating insurers seeking to meet their targets.

Q16: Do you agree that the Flood Insurance Obligation has the potential to meet the policy objective?

Q17: Do you agree that the Secretary of State should have the power to exempt some firms operating in the UK domestic insurance market from the Obligation, e.g. those with market share below a *de minimis*?

Q18. Do you agree that at this stage Ministers should have the option of applying the Obligation to both buildings and contents insurance?

The role of the administrator

We propose that the Secretary of State be granted the power to designate a particular body or bodies to create and maintain a register of domestic properties at high risk of flooding. The definition of ‘high-risk’ for the purposes of the obligation and the criteria for allowing households to opt-in where they are not automatically included would be set out in secondary legislation and would be subject to further consultation. Initial analysis suggests that, if the register included homes at greater than a 1 in 100 year risk of flooding from rivers and the sea, around 500,000 properties would be included on the register. In addition, households at risk of flooding from surface or ground water flooding could be given the opportunity to join the register if certain criteria were met.

The following bodies are responsible for flood-risk mapping in the UK and hold the necessary data to create and maintain a register: the Environment Agency (England), Natural Resources Wales, the Scottish Environmental Protection Agency and the Department of Agriculture and Rural Development, Northern Ireland. We would therefore propose to appoint the Environment Agency and its counterparts in the Devolved Administrations as the administrators of the register for their own jurisdictions.

We envisage that the administrators would be required to have the following roles:

- Identifying the properties eligible for inclusion on the register. This would also require the administrators to liaise with other bodies in their jurisdictions that hold relevant data (such as Lead Local Flood Authorities in England).

- Notifying relevant parties about which households are on the register.

- Handling opt-in and opt-out requests and appeals for households that wish to add or remove their address from the register.

In addition, we intend to appoint a ‘lead administrator’ to coordinate with the national administrators and oversee the creation of a UK-wide register. We propose appointing the Environment Agency to take on this role. As the lead administrator the Environment Agency’s powers would include:

- creating and maintaining the final UK-wide register;

- making sure the criteria used to identify high-risk properties across the UK are consistent;

- making the data publicly available (subject to appropriate privacy safeguards), and ensuring that the addresses of eligible households are available to regulated insurance companies and licensed brokers, and to the regulator.

We intend to take powers in the Water Bill to enable the Environment Agency to fulfil this function, for example by imposing duties on the national administrators to share information relevant to the creation and maintenance of the register.

We will be exploring options for funding the ongoing management of both the UK-wide and the national registers during the consultation period.

Q19: Do you agree that the Environment Agency should be granted powers to act as a ‘lead administrator’, working with the devolved administrations to compile a UK-wide register that lists by address each domestic property at high risk of flooding?

The role and duties of the regulator

We propose that the Secretary of State or relevant Minister be conferred with the power to designate a particular body or bodies to monitor and enforce insurance companies’ compliance with their obligation. Penalties or costs would need to be set sufficiently high to provide the incentive for insurers to compete to provide cover to target households (as a cheaper alternative to paying the penalty), but not so high as to introduce instability to the market (e.g. to avoid insurers having to offer extremely cheap insurance to avoid paying punitive fines). The compliance requirements also need to balance consumer protection with the need to avoid creating an incentive to withdraw from the UK domestic insurance market altogether.

There are a number of possible approaches to supervision of the Flood Insurance Obligation, ranging from a regulated regime, where a regulator reviews insurers’ compliance, to a self-regulated regime, where insurers monitor their own compliance. The detail of the duties and powers of the regulator will depend on the final design of the regime, and the choice of the regulator. As part of this consultation the Government welcomes views on both these questions.

However, in broad terms, depending on detailed design decisions, the duties and powers of the regulator could include:

- Ensuring insurers correctly identify their share of the obligation;
- Ensuring insurers meet their targets (for the agreed time period);
- Taking enforcement action (for example imposing fines) where targets are missed;
- Publishing details of insurance companies’ behaviour with regard to the obligation.

Supervisory framework: monitoring compliance with the obligation

At one end of the scale, a regulated approach to supervision could involve the regulator scrutinising compliance data from each firm to verify its adherence to the obligation. This would offer maximum oversight, and therefore assurance to Government and the public that insurers are complying with the obligation.

On the other hand, a purely self-regulated administrative regime could put the onus entirely on firms to monitor their own compliance with the obligation and only report breaches to the regulator. This would require no active monitoring on the part of the regulator, who would only need to consider appropriate enforcement action if a breach was reported. This approach relies entirely on reliable information being provided to the regulator.

In between the above two approaches would be an audited regime. Independent auditors would be required to review insurers' compliance with the Obligation and notify regulators of breaches.

Enforcement framework: sanctions for non-compliance

The regulator would be have the power to impose regulatory sanctions on insurers who failed to either fulfil their quota of insurance policies for households in high flood risk areas or to provide evidence and records of traded obligation credits. Again, there are a range of choices from a fixed enforcement regime through to a fully discretionary regime.

A fixed regime could involve setting out in secondary legislation or guidance the specific enforcement action to be taken by the regulator in response to different levels of breach. This would be a simple approach with a lower operational burden and cost to the regulator, and would give firms, Government and consumers a clear expectation of how breaches will be sanctioned. However it could also limit the flexibility of the regulator to tailor its response to the specific circumstances of the breach, which might mean that insurers could be disproportionately penalised for genuine mistakes, to the detriment of their customers who might ultimately bear the cost, or alternatively receive only light penalties for repeat and deliberate breaches (if each was on a small scale). Alternatively, a fully discretionary regime could allow the regulator to choose what (if any) enforcement action to take from the powers made available to it, for example financial penalties or public censure. This approach to enforcement is commonly used by both the Financial Conduct Authority in regulating the financial services sector and the Environment Agency in regulating various environmental policies. This type of enforcement approach would be familiar to insurance firms and would give the regulator flexibility to adapt their enforcement action according to the nature of the breach. However, it could be more onerous to apply, more resource intensive and therefore more costly.

A hybrid regime is also possible. In this instance set *ranges* of enforcement action relating to different levels of breach could be set out in secondary legislation or guidance. This would provide firms with a broad indication of the enforcement action they may face, whilst allowing the regulator some flexibility to adjust its response according to the specific case.

Whichever option we adopt, the regulator would also be required to report to Government on overall compliance with the Flood Insurance Obligation within the insurance industry.

Q20. Do you agree with the broad duties envisaged for the regulator? Is anything missing?

Q21. Which of the above approaches to supervising compliance with the Obligation do you believe is best suited to delivering the policy objective whilst minimising the burden on businesses and consumers? Is there another approach not considered here?

Q22. Which of the above approaches to imposing sanctions for non-compliance with the Obligation do you believe is best suited to delivering the policy objective whilst minimising the burden on businesses and consumers? Is there another approach not considered here?

The choice of regulator

There is currently no single regulator in the UK with expertise in both flood-risk mapping and regulation of the financial services industry. The Environment Agency and its devolved counterparts have expertise in flood-risk mapping and regulation of environmental policies, and the Financial Conduct Authority has experience of regulating the financial services sector.

The Environment Agency and its counterparts would already be involved in the obligation as the administrator of the register. The Environment Agency's territorial remit is England-only, so its remit would need to be extended to be UK-wide for the purposes of enforcing the obligation. It would not be appropriate or efficient for different regulators to enforce the obligation in different parts of the UK.

The Environment Agency has experience and expertise in regulating environmental policies in relation to a wide range of sectors. However it does not currently have expertise or experience in regulating financial services, or existing relationships with insurance companies. This would either make a fixed enforcement regime necessary or, if a discretionary enforcement regime were put in place, the Environment Agency would need significant input from the Financial Conduct Authority and the Prudential Regulation Authority when taking enforcement decisions.

The Financial Conduct Authority's (FCA) role is to ensure that markets in financial services function well via securing an appropriate degree of protection for consumers, promoting effective competition and protecting and enhancing the integrity of the UK financial system. In the financial services sphere, insurance firms are dual-regulated: by the Prudential Regulation Authority (as prudential regulator) and by the FCA (as conduct regulator). The FCA has existing relationships with insurers and expertise in financial services regulation, as well as a UK-wide remit. Appointing the FCA as regulator could allow this experience to be used directly in supervision and enforcement of the obligation. However, enforcing the flood insurance obligation would represent a new function for the FCA. This could result in tensions with the FCA's existing objectives (for example the FCA's objective to promote effective competition), which would need to be considered in detail in implementation. The FCA would also need to work closely with the Environment Agency as the lead administrator.

If the FCA were appointed as the regulator then the Financial Services and Markets Act (2000) would need to be modified and extended to reflect these new duties. The FCA's fee-raising powers would also need to be extended to recover the costs of regulating the obligation. Equally, new powers in primary legislation would be required to enable the

Environment Agency to take on this new role, including a power to recover its costs through a fee structure.

Following consideration of the issue, our preference is for the FCA to take on the regulatory role, working closely with the Environment Agency as the lead administrator.

Q23. Do you agree with our preference that the Financial Conduct Authority should supervise compliance with the obligation, and be responsible for taking regulatory action against insurers who fail to meet their obligation, or should it be or the Environment Agency?

8. Next steps

We want to listen to those affected by the issues raised in this consultation, learning from the expertise and personal experiences of policyholders to improve our understanding of how the insurance market in flood risk areas is developing. We are also monitoring the insurance market to collect and analyse data on domestic property insurance in flood risk areas to understand better how the market is changing.

During the consultation period we intend to canvas views from a range of groups. We will do this through existing channels of communication with the insurance industry as well as those with an interest in managing flood risk. Established stakeholder forums on flood risk management exist in England, Wales, Scotland and Northern Ireland and these may be useful mediums through which views can be heard.

We want to hear from households in flood risk areas, the insurance industry and other interested parties about their views on the proposed approach to addressing the affordability and availability of insurance in flood risk areas.

We'll look carefully at all responses we receive to the consultation as we develop the powers for Flood Re and the Flood Insurance Obligation, for inclusion in the Water Bill.

9. Responding to this consultation

Responses to this consultation should be received by 8 August. Responses received after the closing date will not necessarily be considered.

Please respond to the consultation using the **online survey** tool. This is the easiest way to respond. https://consult.defra.gov.uk/flooding/floodinsurance

You can also contact us by **email:** floodinsurance@defra.gsi.gov.uk

Or by **post:**

Flood Insurance consultation

Department for Environment, Food and Rural Affairs

3rd Floor, Zone C, Nobel House

17 Smith Square

SW1P 3JR

10. Summary of consultation questions

Q1. Do you have any evidence of small businesses experiencing difficulty with the availability and affordability of property insurance due to the risk of flooding?

Q2. Do you agree with the Government's policy objective for flood insurance?

Q3. Do you agree with the approach taken to analysing the different potential solutions in the Impact Assessment?

Q4. Do you agree with the evidence presented in the Impact Assessment?

Q5. Do you have any further evidence which has not been considered in the Impact Assessment?

Q6. Do you support the Government's proposed approach?

Q7. If the remaining challenges associated with Flood Re prove too difficult to overcome, what factors do you think should be taken into account ahead of any decision on whether or not to introduce the Flood Insurance Obligation?

Flood Re

Q8. Do you agree that setting the eligibility thresholds according to council tax bands (or their equivalents in the Devolved Administrations) will help ensure Flood Re support is targeted towards those households who need it most, without requiring significant administration? Is there a better method?

Q9. Do you have any views on the proposed initial “eligibility thresholds” within Flood Re (table 1 above), which would effectively cap the technical flood risk premium paid by high risk households?

Q10. Do you agree that the following should be excluded from Flood Re:

a. Band H properties?

b. New homes built after January 2009?

c. Genuinely uninsurable properties? If so, how would you define these in a consistent way that insurance companies can apply?

Q11. Should other exemptions also apply?

Q12. Do you agree that Flood Re should apply to both buildings and contents insurance?

Q13. Do you have any comments on this proposed way of managing Flood Re's exposure to large losses?

Q14. Do you think a levy equating to around £10.50 per UK household, which the ABI estimate is equivalent to the current cross-subsidy, is acceptable to help address the problem of securing affordable flood insurance for high risk households?

Q15. Do you agree that Flood Re will secure the availability and affordability of household flood insurance in the UK?

Flood Insurance Obligation

Q16: Do you agree that the Flood Insurance Obligation has the potential to meet the policy objective?

Q17: Do you agree that the Secretary of State should have the power to exempt some firms operating in the UK domestic insurance market from the Obligation, e.g. those with market share below a *de minimis*?

Q18. Do you agree that at this stage Ministers should have the option of applying the Obligation to both buildings and contents insurance?

Q19: Do you agree that the Environment Agency should be granted powers to act as a 'lead administrator', working with the devolved administrations to compile a UK-wide register that lists by address each domestic property at high risk of flooding?

Q20. Do you agree with the broad duties envisaged for the regulator? Is anything missing?

Q21. Which of the above approaches to supervising compliance with the Obligation do you believe is best suited to delivering the policy objective whilst minimising the burden on businesses and consumers? Is there another approach not considered here?

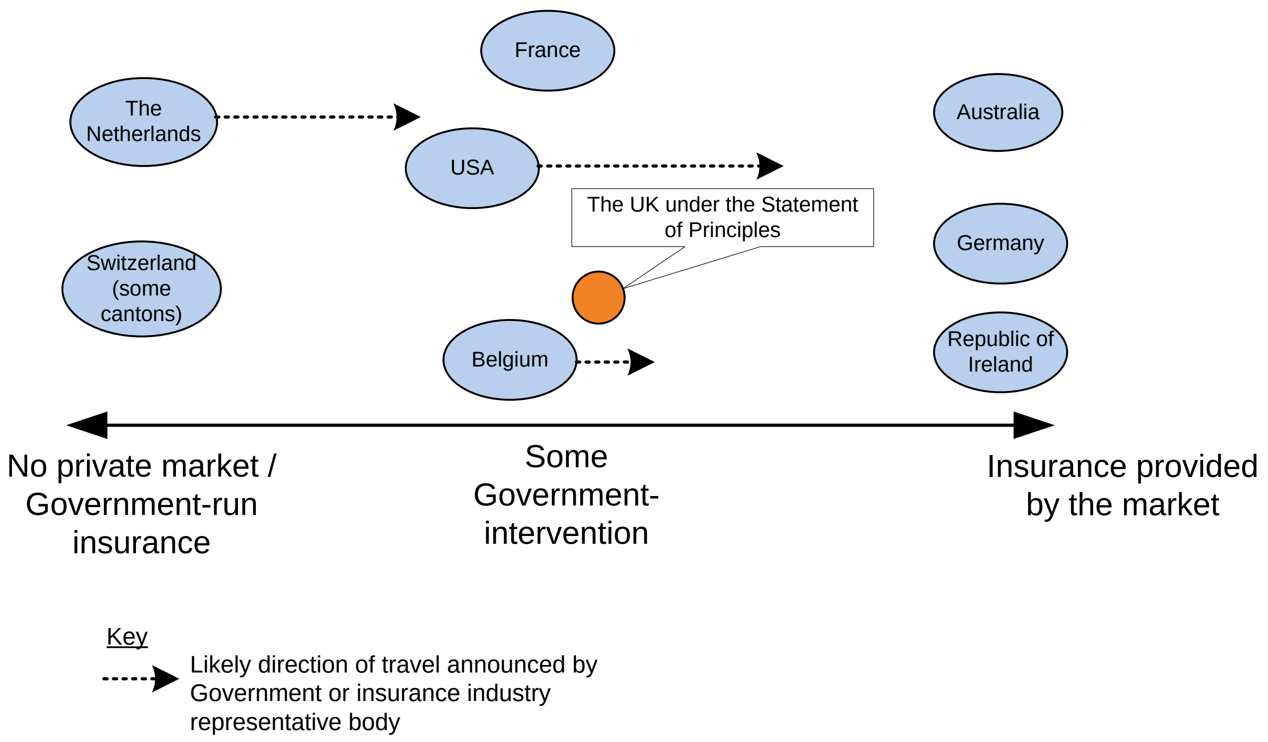
Q22. Which of the above approaches to imposing sanctions for non-compliance with the Obligation do you believe is best suited to delivering the policy objective whilst minimising the burden on businesses and consumers? Is there another approach not considered here?

Q23. Do you agree with our preference that the Financial Conduct Authority should supervise compliance with the obligation, and be responsible for taking regulatory action against insurers who fail to meet their obligation, or should it be or the Environment Agency?

Annex A: Approaches in other countries

International comparisons provide no clear model for managing the financial risk of flooding in the UK. The examples below are representative of the range of situations in different countries where a significant proportion of households are located in areas at risk of flooding.

Figure 5: International approaches to flood insurance



No private market: The Netherlands

Unlike in other countries the exposure to flood risk in The Netherlands is very high, more than two-thirds of homes are located in areas at risk of flooding. Since the 1953 North Sea storm surge that devastated large parts of the country, cover for flooding has typically been excluded from home insurance policies.

Historically taxpayer-funded compensation has been provided on an ad-hoc basis to households who have incurred property damage as a result of flooding. Legislation sets out the circumstances in which the Government will provide compensation for losses and damage caused by storm surges are excluded from the terms of the compensation. The amount of compensation that can be paid out in any one year is also limited by the legislation.

The Dutch insurance industry is interested in the potential for greater private sector involvement in flood insurance. The Dutch Association of Insurers favours a surcharge on all buildings and contents policies to pay the claims of flood-affected households up to a specified threshold per flood event[30]. By contrast one Dutch insurer has recently started providing stand-alone cover for flooding to customers on risk-reflective terms[31].

Some Government intervention: USA

In the USA there is a private market for flood insurance although cover for flooding is not included as standard in domestic insurance policies. Instead there is a state-backed 'National Flood Insurance Program' (NFIP) that enables households in participating communities to purchase cover for flooding if their communities adopt regulations to manage flood risk to new development. Private insurers participate in the scheme although the federal Government assumes the financial risk.

The NFIP was in debt to the taxpayer by US$17 billion as a result of Hurricane Katrina and emergency legislation was required in January 2013 to increase the fund's borrowing authority by $9.7 billion to enable claims to be paid following further claims on the fund as a result of Hurricane Sandy which struck in October 2012.

Other legislation has also recently been passed in order to remove premium subsidies and move toward risk-reflective premium pricing, with rates increasing by 25% per year for certain households until risk-based prices are achieved.

Private market: Australia

In Australia there is a private market for flood insurance. Before the mid 2000s cover for flooding was not included as standard in home insurance policies but now around 80% of policies now include flood cover as standard, with some insurers offering it on an opt-out basis.

The Federal Government announced in March 2013 that it had decided not to subsidise domestic or business property insurance, either directly or by underwriting a flood reinsurance pool. The Insurance Council of Australia welcomed this and said it "believes government subsidies would distort the insurance market, might not assist those most at need, and may serve to encourage rather than discourage development in at-risk communities". Instead the ICA considers that "[f]urther efforts must be undertaken... to remove or reduce hazards to acceptable levels"[32].

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[30] Verbond van Verzekeraars (2013) https://www.verzekeraars.nl/Actueel/Paginas/Home.aspx
[31] Lloyd's (2013) Lloyd's supports unique flood solution in the Netherlands http://www.lloyds.com/news-and-insight/news-and-features/environment/environment-2013/lloyds-supports-unique-flood-solution-in-the-netherlands
[32] Insurance Council Australia (2013) ICA welcomes Productivity Commission report. Media release. 15 March 2013

Annex B: Managing the risk of flooding in the UK

Managing the risk of flooding is the best way of addressing the long term availability and affordability of insurance for households in areas of flood risk. This annex sets out the approaches to managing flood risk in England, Wales, Scotland and Northern Ireland.

Flood risk management is a devolved matter for the purposes of the devolution settlements in Scotland, Wales and Northern Ireland, and as such they fall within the legislative competence of the relevant Devolved Administrations. This annex has been produced in collaboration with the Devolved Administrations.

England

Flood risk management overview

The Flood and Water Management Act 2010 sets out how the Environment Agency, local authorities, internal drainage boards and water companies should work in partnership to manage coastal and flooding risk in England and Wales.

The Environment Agency is responsible for taking a strategic overview of the management of all sources of flooding and coastal erosion. As part of its strategic overview role, the Environment Agency published a National Flood and Coastal Risk Management Strategy for England. The strategy provides information designed to ensure that the roles of all those involved in managing risk are clearly defined and understood.

Lead Local Flood Authorities (unitary authorities or county councils) are responsible for developing, maintaining and applying a strategy for local flood risk management in their areas and for maintaining a register of flood risk assets. They also have lead responsibility for managing the risk of flooding from surface water, groundwater and ordinary watercourses

Improving understanding of flood risk

The Environment Agency produces a national assessment of the likelihood of flooding from rivers and the sea. This data is made available to the public and to insurance companies.

Anyone can access the same information that the Environment Agency makes available to insurance companies by checking the maps available on their website. These maps allow anyone to find out what the likelihood of flooding from rivers and the sea is in a particular local area. Additional information, such as maps on surface water flooding, may also be available through the relevant lead local flood authority or local Environment Agency office.

Approach to flood risk management investment

In England the new Partnership Funding approach means that investment levels are not constrained by what Government alone can afford. It increases certainty and transparency over the level of Government funding for each potential flood defence project so that local choices can be made over the nature and timing of defence works.

Government funding in England is targeted towards those most at risk and living in the most deprived areas of the country. This funds community-scale flood defences as well as property-level flood protection measures for individual household (typically up to £4,750 is available per household). Property-level flood protection measures can also be funded by levies raised by Regional Flood and Coastal Committees and through discretionary awards by local authorities.

The flood and coastal risk management scheme map on the Environment Agency website shows locations in England where flood and coastal erosion risk management schemes to reduce the risk of flooding from rivers, or the sea will be carried out in the 2013/14 financial year. Around 64,000 households are expected to benefit from improved protection when these schemes are completed.

Preparing for and responding to emergency events

The Flood Forecasting Centre was set up in 2009 and is operational 24 hours a day, 7 days a week. It provides high quality forecasting services for local emergency planners and responders and also produces a public three-day flood risk forecast available on the Environment Agency website, giving households forewarning of the likely conditions so they can take appropriate action.

The Environment Agency website also publishes live river and sea level data from their monitoring stations.

Over 1.1 million people are signed up to receive Environment Agency flood warnings, which can be sent by email, text, or a message to a landline or mobile phone.

Wales

Flood risk management overview

In November 2011 the Welsh Government published their first National Strategy for Flood and Coastal Erosion Risk Management in Wales. The National Strategy sets out the following four overarching objectives for managing flood and coastal erosion risk and establishes a delivery framework that meets the needs of Wales now and in the future:

- reducing the consequences for individuals, communities, businesses and the environment from flooding and coastal erosion;
- raising awareness of and engaging people on flood and coastal erosion risk;
- providing an effective and sustained response to flood and coastal erosion events; and

- prioritising investment in the most at risk communities

Implementing these objectives is the responsibility of everyone involved in or affected by flooding or coastal erosion including the Welsh Government, the Welsh Risk Management Authorities and the people of Wales. Environment Agency Wales has been a key delivery agent and on 1 April 2013 their work transferred to the Natural Resources Body for Wales.

Supporting the National Strategy are the Local Strategies, currently being prepared by the Lead Local Flood Authorities. These strategies will be consistent with the national strategy and address local flood risk management issues.

Improving understanding of flood risk

Flood risk and hazard maps are currently being prepared and will provide more up-to-date assessments of flood risk by the end of 2013.

Natural Resources Wales, as part of its Flood Awareness Wales campaign, began Community Flood planning in January 2011, targeting 242 geographical communities across Wales. In 2012 the Environment Agency completed 217 flood plans and tested over 80, with the level of testing varying from simple table top/talk through exercises to a more complicated walk through. The feedback received has been very positive and has been used to initiate many tangible improvements, including more realistic timings and communication within communities, revised local plans and improvement to existing emergency response plans and greater appreciation and clarity of the flood warden role.

Approach to flood risk management investment

Research commissioned in 2012 by the Welsh Government looked at the economic benefits of the flood and coastal erosion risk management programme. Based on a £100 million investment, the findings revealed that estimated job losses avoided over the 100 year life of the infrastructure range from a minimum of 6,380 to a maximum of 38,282 FTE. In addition, with two thirds of the money spent, 930 direct or indirect jobs have been created to date. These benefits are in addition to homes and businesses with reduced flood risk and improved environmental, tourist and regeneration opportunities.

Preparing for and responding to emergency events

The response to all flooding incidents is handled by responders at the local level. This could range from minor impacts affecting a few houses to major emergencies affecting hundreds of properties where a full multi agency response would be coordinated by Local Resilience Fora through a Strategic Coordination Group.

The Civil Contingencies Act 2004 requires responding organisations to maintain plans for preventing, reducing, controlling or mitigating the effects of emergencies. Effective and well-rehearsed emergency plans at organisational and multi agency level will help enable a consistent and coherent response to flooding incidents.

Wales responders work within Local Resilience Fora partnerships to develop and improve multi agency flood plans and generic reservoir plans for the four Local Resilience Fora areas. The Welsh Government has also provided funding to selected local authorities assist in the development of specific off-site plans for the six highest risk reservoirs in Wales and the associated warning and informing activity.

In parallel with this, the Welsh Government has developed the Wales Flood Response Framework in partnership with responders. This Framework provides responders with the information, guidance and key policies in a single strand of planning for flooding emergencies, providing a resource for all tiers of government, responders and other key external partners.

Where major flooding is expected or occurs, the Welsh Government provides support to the multi-agency response, particularly in respect of facilitating mutual aid and playing a central role in consequence management and recovery.

Scotland

Flood risk management overview

The Scottish Government supports a number of strands of work to protect the Scottish public and communities from the risk of flooding. Some of this is done directly by the Government through the development of policy. Much is done by bodies such as the Scottish Environment Protection Agency (SEPA) and local authorities, supported by Government funding, and by Scottish Water.

The Flood Risk Management (Scotland) Act 2009 requires SEPA, local authorities and Scottish Water to develop an integrated approach to flood risk management that accommodates the need for national consistency and strategic decision-making with local knowledge and accountability. This integrated approach will be embodied in the preparation, approval and implementation of Flood Risk Management Plans. The plans will take a risk-based, long term and sustainable view to catchment management and will allow Scotland to move beyond reactive flood management where investment and action have tended to follow recent flooding rather than pre-empt it. This catchment-led approach requires SEPA and the responsible authorities to work together to identify a range of actions across administrative boundaries.

Improving understanding of flood risk

Scotland's first National Flood Risk Assessment (NFRA) was published in 2011 and provides for the first time, a national picture of flood risk across Scotland.

SEPA are now working on the production of new flood risk and hazard maps by the end of 2013 and the first National Flood Risk Management Plan by the end of 2015.

A project is also underway to gather a more accurate understanding of surface topography through aerial LiDAR surveying in order to improve flood hazard modelling and mapping. The second phase of this project is due to be completed later this year. Another project is developing a high resolution 'Detailed River Network' for Scotland, this will help assess river flows more accurately and develop a better understanding of the risk of flooding across Scotland. A 'beta' version of the new DRN dataset is expected to be complete by the end of the year and will be available to all Scottish public bodies free of charge for non-commercial use.

The Scottish Government are working with SEPA and the other responsible authorities to improve access to flood risk related data for both organisations and individuals.

Approach to flood risk management investment

Prior to the spending review period 2012-2015, a new distribution methodology for flooding component of the General Capital Grant was agreed. The new distribution methodology is to allocate the flooding component only to large flooding projects. The projects currently receiving funding have first call on the monies available. Local authorities were invited to apply for this element of the grant. Funding decisions are made in partnership by the Scottish Government and Convention of Scottish Local Authorities (CoSLA).

Local authorities remain free to allocate additional resources to flooding from within the overall funding provided to them by the Scottish Government and from within their own resources.

Preparing for and responding to emergency events

The Scottish Government has published information online for the public about preparing for emergencies. Ready Scotland (www.readyscotland.org) provides a range of information about how to lessen the effects of the main risks we face, including severe weather and flooding, and about the measures that we can all take to prepare ourselves, our families, our homes and businesses.

The Scottish Government provided SEPA with £560,000 to establish the Scottish Flood Forecasting Service in partnership with the Met Office; this has improved the information available to local responders enabling them to proactively deal with potential flood events.

The Flood Risk Management (Scotland) Act 2009 places a duty on SEPA to provide flood warning in Scotland and a national flood warning dissemination system (Floodline) has now been operational since March 2011.

The public can access flood warning information via the Floodline service by telephone, on the internet, or via the Direct Warning Service.

On 28 January 2013, SEPA launched 28 new coastal flood warning schemes to provide coastal flood warnings to residents and businesses in the Forth and Tay coastal areas so that they can take action and prepare for flooding in advance. SEPA now has 247 flood warning target areas across Scotland and further flood warning schemes are planned.

Northern Ireland

Flood risk management overview

Historic investment in flood alleviation has reduced the risk of flooding to people and property, however, a significant element of risk remains. An ongoing programme of flood alleviation schemes seek to maximise the benefit to people and property. In delivering flood alleviation the risk of flooding to new and existing development is also taken into account. Asset Management Plans and an ongoing cycle of inspection, assessment and intervention ensures the effective functioning of drainage systems and flood risk defence assets.

Improving understanding of flood risk

The Preliminary Flood Risk Assessment for Northern Ireland, completed in December 2011, clearly indicated the areas at significant flood risk. This analysis complimented the Strategic Flood Maps, which have been publically available since 2008. The next release of detailed flood maps, which are required under the EU Floods Directive to be published by December, will provide even greater information on the level of flood risk to communities.

Approach to flood risk management investment

In Northern Ireland just over £36 million is spent each year on capital improvements to flood defence and drainage systems. In addition £24 million is spent on the maintenance of flood defences and drainage infrastructure, such as open watercourses, culverts, storm water systems and road drainage.

Preparing for and responding to emergency events

Rivers Agency in conjunction with the Department for Regional Development Road Service and Northern Ireland Water and a range of other responders promote a joined-up approach to flood emergency response to help people cope with flood emergencies.

The Agency has continued to develop its emergency planning functions in line with the Northern Ireland Civil Contingencies Framework, the Department's Integrated Emergency Management Development Plan and within the context of the Agency's Flood Emergency Plan.