Response by Flood Re Limited to the consultation on the Flood Reinsurance Scheme Regulations

1. Background to Flood Re Limited ("Flood Re")

1.1. The Association of British Insurers ("ABI"), on behalf of the UK insurance industry, and UK Government agreed a Memorandum of Understanding ("MoU") in Summer 2013 to establish a scheme aimed at promoting the availability and affordability of flood insurance in high flood risk areas.

1.2. Flood Re Limited ("Flood Re") was established by the ABI as a company limited by guarantee following publication of the MoU and it is intended that it will become an industry-owned and run company that will function as the reinsurance facility designated in secondary legislation, pursuant to the Water Act 2014 ("the Water Act"), as the Flood Re Scheme Administrator.

1.3. ABI members are currently funding the set-up of Flood Re on the basis of the agreement reached in the MoU. Flood Re directors currently consist of:

- Tom Woolgrove, Interim CEO and former UK personal lines Managing Director of Direct Line Group
- Otto Thoresen, current Director General of the ABI; and
- Huw Evans, current Deputy Director General of the ABI.

1.4. Flood Re is working in partnership with the Government to implement the scheme and is, in particular, currently progressing a number of important project work streams, including:

- The procurement of a managing agent to manage Flood Re's operational processes, and a reinsurance broker to advise on and implement its reinsurance programme;
- Developing the submission of an application to obtain regulatory authorisation from the PRA and FCA, required under financial services legislation for Flood Re to function as a reinsurer. This includes capital modelling for establishing an internal model required for Solvency II and other regulatory purposes;
- Developing the required corporate governance framework, which will feed into regulatory authorisation;
- Planning for and working with the Government to implement the industry council tax data hub that will be central for insurers to underwrite flood risks ceded to Flood Re.
- Regular engagement with Government officials on the delivery of the scheme.

1.5. Brendan McCafferty, currently Commercial Director at Paymentshield, will become the permanent CEO of Flood Re in Quarter 4 of 2014. Appointments for a CFO, Chair, Actuary and the rest of the Board are expected by Quarter 1 of 2015.

2. Executive Summary

2.1. Flood Re directors are in active dialogue with Defra and HMT in what continues to be a constructive partnership. Flood Re, alongside the insurance industry, remains committed to ensuring the success of the flood reinsurance scheme, which is the preferred option for stakeholders, has cross-party support and (subject to a number of alterations to the draft regulations) is the preferred industry solution. The scheme is a world-first and will provide vital assistance to those householders situated in high flood risk areas in accessing affordable home insurance in the UK over the next twenty-five years.

2.2. Despite on-going dialogue, it is important that Flood Re publically notes deficiencies within the draft regulations as consulted on. Flood Re presently considers that the draft regulations consulted on are not workable and will, consequently, not achieve the policy objective of an industry-led solution to promoting the availability and affordability of flood insurance whilst transitioning to risk-reflective prices.

2.3. We welcome the constructive process Defra has engaged in since the publication of the draft regulations in its efforts to resolve these issues. Whilst questions specifically raised by the Government in the consultation document consider important aspects of the scheme as a whole, we have detailed below issues that are fundamental to the scheme's operation that need to be changed if the development of the scheme is to progress. These include:

- The current statutory requirement not to impact public sector net borrowing ("PSNB") by more than £100m at the end of the financial year under Regulation 17(1)(d), which is a requirement no operator of the Flood Reinsurance Scheme envisaged in the Water Act can guarantee at any future time;
- A wide-ranging power in legislation to call additional amounts from relevant insurers as levy (tax), rather than capital contributions, at any time under Regulation 10(1), which could potentially result in volatility for insurers' profitability and impact wider household premiums (contrary to what was agreed in the MoU);
- The failure to make explicit in the regulations that capital contributions provided by relevant insurers can be repaid by Flood Re at the discretion of directors (subject to PRA approval), which again will potentially result in volatility for insurers' profitability and impact wider household premiums;
- Restrictions on Flood Re's ability to borrow under Regulations 17(1)(a) and (1)(b), which will prevent it from operating as efficiently and effectively as it could otherwise.

2.4. Our response considers these fundamental issues in more detail and raises further issues on the eligibility of Band H homes, the transition to risk reflective pricing and the importance of clarity in the definitions outlined in the regulations. The response then considers each question posed by the Government in turn and considers legal or drafting issues arising from the draft regulations.

Fundamental Issues

3. **Flood Re directors cannot guarantee that Flood Re will not make a loss of more than £100m as at the end of any financial year, as required in Regulation 17(1)(d). This requirement, included purely for presentational purposes with regard to Government borrowing figures, is disproportionate and unrealistic for a company intended to cover volatile flood risks, and is unacceptable for Flood Re and the insurance industry.**

    3.1. Regulation 17(1)(d) makes it a requirement that Flood Re does not add to Public Sector Net Borrowing ("PSNB"), as determined by application of the European System of Accounts ("ESA"), by more than £100m as at the end of any financial year. This requirement means, in broad terms, that Flood Re will be under a legal obligation not to make a loss on its Profit and Loss account (P&L) of more than £100m if it is classified as a public body by the Office of National Statistics ("ONS"). This is intended to reflect the Government's broader policy objective of reducing UK deficit and debt.

    3.2. However, under this provision, Flood Re directors will be legally responsible for damage and loss caused as a result of a breach, regardless of culpability or fault. Flood Re directors could be operating outside the law as a result of circumstances outside their control e.g. a large loss leading to liability to pay claims before entitlement to receive reinsurance recoveries arises; failure of retrocession cover; a law suit against Flood Re that means its expenditure is more than envisaged; or other reasonably unforeseen circumstances.

    3.3. Insurers generally manage their P&L through what is termed the "insurance cycle", over multiple years. During this cycle, (re)insurers' P&Ls are inevitably volatile due to the nature of the risks taken on. Some years will unavoidably see losses if there is, for instance, a higher than expected volume of claims. Losses in these circumstances are often outside the control of directors and are a normal course of (re)insurance business. Losses are offset against profits made in years where loss events are fewer and/or less serious than expected. Insurers, therefore, routinely assess profitability across multiple years. In light of this, insurers' (and shareholders') key area of concern during the financial year is usually Balance Sheet capital and solvency levels relative to regulatory capital requirements, as opposed to P&L impact. This is also reflected in the regulatory emphasis on capital adequacy.

    3.4. A normal reinsurer will not always raise more capital in the event of a loss above £100m, if it already has sufficient capital - losses are a normal part of the reinsurance cycle. Irrespective of the P&L, additional funding may be required simply because the PRA states that Flood Re needs to hold more regulatory capital.

    3.5. Flood Re directors do not have the means to ensure that Regulation 17(1)(d) is not breached:

        - Regulation 17(1)(d) effectively means that Flood Re cannot have a £100m loss on its P&L at the end of the financial year. Flood Re cannot rely on member capital contributions (recorded on its Balance Sheet) to cure a P&L problem.

- In order to meet this statutory obligation, Flood Re would have to consider raising further funds as additional levy. Raising additional levy would be an expense to relevant insurers to be recognised on Flood Re's P&L as income, resulting in P&L volatility for insurers. This could also reduce insurers' solvency, as additional levy could have a direct impact on capital resources.

- Treatment of additional amounts as levy rather than contractual capital contributions as a means of preventing or rectifying a breach of Regulation 17(1)(d) is, therefore, not acceptable. It is directly contrary to the agreement reached in the MoU that the overall effect of top-up amounts on insurers *"is* [capital] *neutral over time"* and minimises *"the potential* [P&L] *volatility this could cause to the accounting treatment of member firms"*. This would likely adversely affect consumers, since costs are likely to be passed down.

- Whilst outwards reinsurance can protect against losses to an extent, there is no way of guaranteeing that market supply will remain affordable or available throughout the twenty-five year lifetime of Flood Re. We cannot build a business model based on the assumption of certain market availability, which was one of the key lessons of the financial crisis. Even If such a reinsurance structure is possible and affordable, it could still be possible for a reinsurer to default on its liabilities meaning that the loss would reside with Flood Re resulting in a breach of Regulation 17(1)(d).

3.6. A breach of this provision could constitute a breach of directors' duties under sections 171 and 173 of the Companies Act 2006, which sets out that a director must act in accordance with the company's constitution and only exercise powers for the purposes for which they are conferred. This would clearly have a personal and reputational impact on Flood Re directors. We have no doubt that this will deter directors with the required expertise signing up to take responsibility for the scheme. Furthermore, insurers are unlikely to reinsure where they can foresee Flood Re's directors being in breach of their duties.

3.7. We are concerned that, if caught by Regulation 17(1)(d), any action taken by Flood Re before or after a breach of this Regulation could be impugned as being outside the powers of its directors according to the provisions detailed in paragraph 3.6. This could lead to disputes concerning the validity of business, including inward and outward reinsurance, entered into by Flood Re which would have a serious impact on the operation of Flood Re as a reinsurance facility.

3.8. We do not consider that a hard limit is workable in the circumstances. Such provisions are usually enacted as a deterrent to reckless or negligent behaviour. Company law and regulatory requirements already provide a means for ensuring, as far as reasonably possible, that directors do not make a loss that can reasonably be prevented (e.g. through the statutory duties under company law and the PRA 'approved persons' regulatory regime). The Government policy objective of reducing levels of UK deficit and debt will not be compromised in the long term since, subject to exceptional circumstances, losses are likely to be short term and rectified in subsequent financial years. Any ring-fenced tax raised by Flood Re will impact positively on public sector

net debt ("PSND") if Flood Re is deemed to be a public body, since it would otherwise be insolvent.

3.9. This provision is in place for presentational purposes only. For an industry-led solution to be fully viable, however, a limit on P&L losses should not remain in place. This is more in line with how (re)insurers in the private sector operate. Without addressing this fundamental issue there is a real danger that insurers will not have sufficient confidence in the scheme's viability, and will feel unable to support its development, financially or otherwise.

4. **We are concerned about the wide-ranging power in legislation to call additional amounts from relevant insurers as levy (tax), under Regulation 10(1), rather than capital contributions (that have a prospect of future repayment).**

4.1. Flood Re will receive two regular income streams from insurers each year: premium income due from policies ceded into Flood Re and an annual primary levy of £180m received from all relevant insurers. Both income sources will be reported as income on Flood Re's profit and loss account (P&L), and treated as expenditure by insurers.

4.2. As agreed in the MoU published in June 2013, and as has been the basis of discussions with the Government throughout the development of Flood Re, any additional funding required by Flood Re beyond its premium income or the £180m annual primary levy must be raised as capital (equity) contributions from relevant insurers.

4.3. Paragraph 41 of the Government consultation document suggests, contrary to this requirement, that 'top-up' amounts over £100m from relevant insurers will be treated as 'additional levy' rather than capital 'contributions' (in which case, there would be no prospect of repayment) in order to manage the impact on public finances.

4.4. Additional levy or contributions with no prospect of repayment would be accounted for as an expense to relevant insurers, causing volatility on their P&L accounts, meaning the scheme is likely to impact on wider household premiums. Avoiding such volatility has always been an industry requirement of Flood Re.

4.5. We are concerned that the regulations as currently drafted allow for unlimited additional amounts to be called as levy/tax instead of capital contributions at any future time, beyond the annual primary levy, which presents an unacceptable degree of uncertainty for insurers and, in turn, their customers.

4.6. Regulation 10(1) needs to be clear that additional levy is raised only where contributions are not payable by relevant insurers by way of contractual capital contributions under the membership agreement in place with Flood Re. An example of this would be where a relevant insurer is not a member of Flood Re.

4.7. We would suggest alternative wording for Regulation 10(1), as follows:

"(1) A relevant insurer must pay by levy any additional amount as may be requested by the FR Scheme administrator from time to time in accordance

with the FR Scheme unless such additional amount is payable by the relevant insurer by way of contractual contribution.

(2) When making a request for any levy under, or contractual contribution referred to in, regulation 10(1), the FR Scheme administrator must comply with the circumstances set out in regulation 11".

Where an additional definition is provided for as follows:

"Contractual contribution" or "contribution" means a sum payable by way of capital contribution by a relevant insurer to the FR Scheme administrator pursuant to a contractual obligation under or by virtue of the FR Scheme".

5. **Regulations 12 and 17(1)(c) need to make clear that additional contributions raised from relevant insurers can be repaid, in accordance with Flood Re's contractual documentation with its members (which would be at the discretion of Flood Re directors)**.

5.1. References need to be included in Regulations 12 and 17(1)(c) that give Flood Re explicit power to apply its income and assets toward repayment of contractual contributions, if the directors elect to do so under contractual documentation and subject to PRA agreement. This is a fundamental issue and key aspect of the scheme for insurers. Whilst paragraph 42 of the consultation document acknowledges this, without explicit reference in legislation, this will not be clear throughout the life of the scheme.

5.2. We acknowledge that any provision for repayment needs to be compatible with regulatory capital requirements. We can ensure that additional amounts received as capital contributions can be classified as Tier 1 capital under Solvency II through making reference to 'contractual' contributions. Flood Re's contractual documentation will set out the repayment mechanism, which will ensure there is no expectation (only a prospect) of repayment, at the discretion of Flood Re directors. The contractual documentation will, in turn, require PRA approval for any repayments of capital contributions. We have also suggested an additional clause (see paragraph 29) relating to needing to comply with regulatory obligations which would assist.

5.3. We would suggest the following alternative wording:

<u>Regulation 12</u>

(1) The FR Scheme administrator may only use the amounts collected under or referred to in regulation 5 and 10 for the following—

(a) the purposes of the FR Scheme; and

(b) the administration of the FR Scheme.

(2) For the purposes of regulation 12(1)(a), "purposes" include any potential repayment of contractual contributions referred to in regulation 10(1), turning assets to account and other purposes incidental to the FR Scheme.

Regulation 17(1)(c)

the FR Scheme administrator may only use, or transfer, any assets relating to the FR Scheme for the purposes and the administration of the FR Scheme.

With an additional clause as follows:

For the purposes of regulation 17(1)(c), "purposes" includes any potential repayment of contractual contributions referred to in regulation 10(1), turning assets to account and other purposes incidental to the FR Scheme.

5.4. To be clear, *'turning assets to account'* is aimed at permitting Flood Re to raise additional funds by (say) renting out spare office space. "Turning assets (or resources) to account" is an expression which is used in legislation giving powers to statutory bodies (e.g. para 13(b) of Sch 11 to the Greater London Authority Act 1999).

6. **Restrictions on borrowing under Regulations 17(a) and (b) are unnecessary and an unjustifiable encroachment on the ability of Flood Re's directors to operate the company.**

6.1. Restrictions on Flood Re's ability to borrow are not justifiable. Any controls set out in legislation should be limited to those required to protect the management of public money, if the ONS classify the levy as taxation. This approach would give effect (as far as possible) to the principle agreed in the MoU that Flood Re would be *'industry owned and run'*. This remains the policy intent, the Government acknowledging in its consultation document that "*Flood Re will, as far as possible, be treated as an autonomous body with operational independence from the Government*".

6.2. Given Flood Re will not impact Public Sector Net Debt ("PSND") under ESA (unless it undertakes long term borrowing, which is unlikely) and should always be solvent whilst designated in legislation, there is no need for legislative control over borrowing. We do not agree with paragraph 25 of the consultation document which states that the aim of this provision (amongst others) is to "*limit Flood Re's impact on the public finances, so that it can operate independently as an industry run and managed body"*.

6.3. Borrowing powers reflect the normal operations of a reinsurance company. Short-term borrowing can often be a more effective and efficient way of managing short-term liquidity issues. Such restrictions exist in other public bodies to ensure they borrow from the Government, thus benefiting from lower costs of borrowing. Unlike other public bodies, however, Flood Re will not be able to borrow from the Government, which means it will be unable to access short-term funding if circumstances require this to meet regulatory obligations (e.g. cash flow issues).

6.4. The current regulations restrict any 'borrowed amount' by Flood Re to £5m. A limit of £5m is very unlikely to cover circumstances in which Flood Re would need to ensure it can effectively manage its working capital requirements.

6.5. In addition, 'borrowed amount' has not been defined. Any definition would, at the very minimum, need to be restricted to loans (bank overdrafts/temporary borrowing) to prevent any adverse impact on PSND, and exclude, for the avoidance of doubt, insurance liabilities, top-up capital contributions or additional levy and amounts owed to suppliers in respect of products or services acquired.

6.6. The prohibition on borrowing from relevant insurers under Regulation 17(b) also unfairly restricts Flood Re's freedom to borrow. Flood Re will borrow from commercial banks, who may in turn own relevant insurers. The key issue relating to this clause is one of principle in that we consider this disproportionately constrains Flood Re, when it is meant to be industry owned and run.

7. **Flood Re's eligibility criteria unfairly exclude Council Tax Band H properties.**

7.1. Flood Re supports the inclusion of Council Tax Band H properties within the scope of the scheme and sees no operational difficulties arising from their inclusion.

7.2. Inclusion of Band H properties is unlikely to bring significantly more properties into the scope of Flood Re and so cost implications are not likely to be prohibitive. These can also be minimised by, for example, determining an appropriate premium level for ceding Band H properties. The inclusion of Band H properties would not result in an increase in overall flood risk (in contrast to including homes built since 2009).

7.3. Council tax bands do not provide a precise measure of affordability. For instance, policyholders of Council Tax Band H properties may be asset rich and cash poor. The original exclusion was inserted by Government in case the purposes of the scheme proved politically controversial. In fact, there has been cross-party support of the scheme and the exclusion of band H properties has been questioned by the Opposition.

7.4. Evidence from ABI members who insure a large proportion of 'high net worth' homes suggests that a significant proportion of Band G properties will have higher sums insured than some Band H properties. The evidence also shows that in last winter's flooding, many of the largest losses were actually from Council Tax Band G properties rather than Council Tax Band H.

7.5. Including Band H would resolve inconsistencies with the approach for reconciling differences with how council tax / equivalent bands are treated by devolved regions.

7.6. Inclusion of Council Tax Band H properties would simplify the operational requirements of Flood Re for insurers, particularly given that there is the possibility of changes to Council Tax banding over the lifetime of Flood Re, either at an individual property level if improvements are made and the property's band is then reassessed when sold, or at a more general level if a Government review of banding takes place. This could mean properties moving in and out of scope of eligibility for Flood Re, which creates operational difficulties for insurers and Flood Re.

8. **Transition Plan**

8.1. Flood Re supports the principle behind transition to risk reflective pricing for flood insurance over twenty-five years and is committed to making recommendations to assist Government in achieving this. However, the fundamental tools to create an environment for risk reflective pricing lie with Government and not with Flood Re. Flood Re can provide the means for ensuring affordable flood insurance over its lifetime, but it is only through the Government setting the levy and premium limits in legislation, combined with flood risk management policy, that flood risk can be managed to an acceptable level, meaning risk-reflective prices beyond Flood Re's lifetime are affordable.

8.2. We have outlined further comments and some suggested changes to the regulations in response to Question 3 below

9. **Definitions**

9.1. Further clarity on the definitions outlined in the regulations will help give confidence to insurers of the basis upon which Flood Re will operate. Clear definitions will allow insurers to accurately assess the terms on which they will be able to cede policies into Flood Re and thereby account for this at point of quote with the customer. A lack of clarity may mean that insurers cannot be sure of the basis upon which a policy is ceded into Flood Re, which could mean additional liabilities for insurers that they had not accounted for.

9.2. We have outlined further comments and some suggested changes to the regulations in response to Questions 7 and 10 below.

Consultation Questions

10. **Question 1: The proposed regulations will ensure that the Responsible Officer is directly accountable to Parliament for Flood Re's operation, and set out specific duties for the Responsible Officer. Do you agree these duties are sufficient (Y/N)?**

10.1. This measure is premised on the anticipated classification of the £180m industry levy as taxation by the ONS. Provided this classification outcome arises, Flood Re is content, in principle, with the accountability measures set out in relation to:

- The appointment of a Responsible Officer, being directly accountable to Parliament (likely to be the Chief Executive Officer);
- Needing to ensure economy, efficiency and effectiveness;
- The laying of accounts in Parliament.

10.2. We are working with the Government to consider further what these requirements mean in practice. We assume these requirements will predominantly focus on accountability for day-to-day operational decisions.

10.3. The consultation document explains that: *'The Government will retain responsibility for general policy matters relating to flood insurance, with Defra being the lead Department and accountable to Parliament for this. The Scheme Administrator, through the Responsible Officer, will be accountable to Parliament for the operations of the Flood Re Scheme"* [page 6]. It also

states that the "*Responsible Officer will be directly accountable to Parliament for…the management of its finances*" [page 7].

10.4. However, the Government are clear that, as a matter of policy, the levy amount and premium limits should be periodically set by the Secretary of State in legislation (albeit after considering recommendations made by Flood Re). Ministers making these longer term decisions will of course have to accept a degree of accountability to Parliament, given these decisions will directly impact on the prudential management of the scheme and fulfilment of Flood Re's regulatory obligations. These variables are also crucial for fulfilling the statutory objectives of the scheme to promote affordability during the lifetime of the scheme and facilitate the transition to risk-reflective prices. As such, we do not consider that there can be a complete separation between Flood Re and Defra on accountability for the scheme's operation as a whole.

11. **Question 2: We are not defining economy, efficiency and effectiveness, propriety and regularity or the public interest in the regulations; we believe their natural meanings are clear. Do you agree with this approach (Y/N)? If you think that these terms need defining, either in legislation or elsewhere, what factors should be considered in their interpretation?**

11.1. We do not have any objection to these terms not being defined. We consider Flood Re should be consulted if or when more detailed criteria or standards are set for assessing these terms. As above, given there will be a split in decision-making between Flood Re directors and the Secretary of State on the financial management of Flood Re, the lines of accountability need to be clear and set out in more detail.

11.2. The 'public interest' benefits of a market solution such as Flood Re necessarily correlate with relevant insurer interests as potential taxpayers through the levy mechanism. Lower costs for relevant insurers ultimately means lower premiums for customers indirectly benefiting from the scheme. This should be made clear in the explanatory notes to the Regulations.

12. **Question 3: Do you think that the publication of a transition plan and provision of information to insurers is appropriate for making insurers and those at highest risk of flooding aware of the transitional nature of Flood Re? If not, what other approach could help householders and insurers understand the transitional nature of the Scheme and help them prepare for the transition to risk reflective prices?**

12.1. Regulation 18 ("Transition to risk reflective pricing for flood insurance") requires the Flood Re Scheme Administrator to provide *"general information"* about the *"estimated impact of…steps [to manage the transition to risk reflective prices] on the amount of the levy and…reinsurance premium…"* as part of formulating a transition plan. Any estimates of levy and premium levels will have to be heavily caveated, in light of the fact that capital modelling assumptions and actual PRA capital requirements will vary over time and cannot be precisely foreseen. Whilst a transition plan will indirectly alert insurers and households of the transitional nature of the scheme in broad terms, the lack of specifics may mean that limited benefit arises (e.g. there will be no quantifiable information on how five yearly changes will impact affordability). Notwithstanding this, Flood Re will be central to formulating recommendations as to the actual levy and premium amounts at

the appropriate five yearly reviews (or sooner as required), based on actuarial modelling available at the appropriate time.

12.2. We are concerned with the drafting of Regulation 18, in light of the statutory purpose of the scheme within the Water Act to *'promote the affordability and availability of flood insurance'*, alongside the need to manage the transition of risk-reflective pricing. Working towards an environment over Flood Re's twenty-five year lifetime in which risk-reflective prices are affordable should be Government's objective. Flood Re can provide the means for ensuring affordable flood insurance over its lifetime, but it is only through the Government's flood risk management policy that flood risk can be managed to an acceptable level, meaning risk-reflective prices beyond Flood Re's lifetime are affordable.

12.3. In the context of climate change, a major shift in approach and resourcing over time will be required in order to achieve affordable flood cover at the end of the life of the scheme, including:

- a zero tolerance approach to inappropriate development in areas at high risk of flooding;
- greater investment in building and maintaining flood defences;
- robust mapping and forecasting systems;
- property-level protection; and,
- if necessary in some cases, relocation.

12.4. Government acknowledges that Flood Re has limited mechanisms at its disposal to achieve a transition to affordable risk reflective prices at the end of the 25 year scheme. However, we do not consider that the current legal drafting reflects this.

12.5. Regulation 18, which refers to the transition plan outlining *'the steps which the FR Scheme administrator will take to manage the transition',* places a statutory duty on Flood Re to manage something that is largely outside its control from a strictly legal sense. The main tools available for effecting a transition are adjusting levy and premium limits. Even if the Secretary of State gives serious consideration to the recommendations made by Flood Re on premium and levy levels, he/she ultimately has discretion in proposing legislation for endorsement by Parliament. In this respect, Flood Re is simply an agent for implementing Government policy. In light of this, as well as premium and levy levels being dictated, to a large extent, by regulatory capital requirements, the extent of Flood Re's ability to manage the transition is limited. Similarly, the primary tool for effectively reducing flood risk on any significant scale also lies with the Government which is responsible for managing flood risk.

12.6. The Regulations cannot create a situation where Flood Re could be vulnerable to legal action for breach of statutory duty for not effectively managing the transition when this will be outside its control. This is clearly objectionable.

12.7. We suggest that Regulation 18 is redrafted as below. This avoids the suggestion that Flood Re has responsibility for managing the transition when in reality this is the role of the Government, who will be publically accountable to Parliament.

18 —(1) The FR Scheme administrator must have regard to the need to manage, over the period of operation of the FR Scheme, the transition to risk-reflective pricing of flood insurance for household premises.

(2) The FR Scheme administrator must produce and publish a plan ~~for achieving~~ relating to the management of the transition referred to in regulation 18(1) (to be known as the transition plan) within 3 months of these regulations coming into force.

(3) The transition plan may contain the following—

(a) the steps which ~~the FR Scheme administrator will take~~ may be taken to manage the transition referred to in regulation 18(1) over the period of operation of the FR Scheme;

(b) general information about the estimated impact of those steps on the amount of the levy and the reinsurance premium thresholds payable under regulation 14 over the period of operation of the FR Scheme;

(c) any other general information relating to the transition plan which the FR Scheme administrator may decide to publish.

(4) The FR Scheme administrator must update and publish the transition plan at regular intervals and at least every 5 years.

(5) The FR Scheme administrator must publish the transition plan and any subsequent updated transition plan by placing it on its website.

13. **Question 4: Do you agree that the funding arrangements in the regulations (including regulation 17 above) achieve the right balance between operational freedom; certainty for insurers; and accountability for the handling of public money (Y/N)?**

    No. See section above titled 'Fundamental Issues'.

14. **Question 5: Are there any practical difficulties with the approach of using Gross Written Premium and "Home Insurance" to calculate the levy for "relevant insurers" (Y/N)?**

    Yes. See below.

15. **Question 6: Do you think that the approach for estimating GWP for insurers who fail to provide this information within the timeframe is fair (Y/N)?**

    15.1. Yes.

    15.2. We also support the current position for not providing specific provision for new entrants. Under Regulation 9, GWP for new entrants would be nil according to the calculation. Practically, it is beneficial for levy payment to commence after one year of trading, once GWP figures are available, given the limited impact the first year of business for new entrants will have on market share. To do otherwise would introduce disproportionate administrative issues for Flood Re in trying to devise a workable system for new entrants and encumbents.

15.3. We are still considering how the regulations could accommodate relevant insurers who restructure and will approach Defra separately on this point as necessary.

16. **Question 7: If no to either of the previous two questions, what changes to this approach should be considered and why?**

Home Insurance

16.1. Levy is payable on the "gross written premium" ("GWP") as defined in the Regulations, which builds on the defined terms "home insurance" and "dwelling" (also as defined). The scope of the levy payment is determined by the definition adopted for "home insurance".

16.2. The Government's current intention is to calculate GWP, using a definition of 'home insurance', on the basis of policies that exactly match the eligibility criteria for cession to Flood Re (including, for instance, the prescribed scope for leasehold properties).

16.3. We consider that the levy calculation definitions require a balance between fairness and workability for insurers. From a practicality perspective, insurers do not collect information on this basis and have indicated it would be prohibitively costly to precisely identify GWP for those policies which are strictly eligible for Flood Re from a systems perspective. This cost will be passed on to customers and makes it more difficult to achieve the policy objective for the scheme not to impact household premium levels more widely.

16.4. The best outcome seems to be to adopt wording that captures as closely as possible what insurers currently classify as domestic buildings and/or contents policies, acknowledging that there are grey areas given some insurers classify these policies differently. We suggest the GWP for those leasehold blocks with three residential units or less, where they meet the required criteria for eligibility, should not be included in the levy calculation. The wording on page 18 of the consultation document should be revised to take account of this. Insurers would not be able to separate out these policies from commercial books to include within the levy calculation as they may not have sufficient information about the number of residential units within specific blocks. The costs of analysing separate cases from commercial books for inclusion in the levy calculation are also likely to be disproportionate. This should not, however, affect the eligibility of these blocks, where they meet the necessary criteria, to be ceded into Flood Re.

16.5. We are currently considering how best to deal with premiums received for 'add-ons' to home insurance and whether these should be included within GWP figures for the purpose of the levy calculation and will communicate with Defra separately on this issue. The regulations and Scheme Document should, however, make the eventual treatment of add-ons clear.

Relevant Insurers

16.6. Certain 'accounting triggers' for the primary levy are required for this to be recognised on "Day One" for capitalisation purposes and to ensure insurers do not have to account for two levy payments in 2015.

16.7. The accounting triggers are:

- Incurring the premiums which are being used to calculate the levy (i.e. insurers need to incur the premiums within the calendar year, which will then be used to calculate the levy due in the following April); and

- Insurers needing to be authorised to write UK household business at the point the levy is due, i.e. in April. On Day One (6 April 2015), it must be possible to identify which "insurers" (as defined in s.82(1) of the Act) are "relevant insurers".

16.8. This presents difficulties in capturing Lloyd's participants, who are not 'authorised' as such and can only be defined by what they do (i.e. writing home insurance business), rather than what they are. We do not consider the current wording works and instead suggest a legislative presumption that assumes Lloyd's participants are still writing home insurance business, subject to them providing evidence to the contrary.

16.9. We would suggest draft wording as follows:

"*A relevant insurer", as at any date in the period commencing on [6 April] 2015 and ending on 31 March 2016 ("the initial period") or any subsequent financial year, is an insurer that –*

(a) effected any contract of home insurance at any time in the period of 12 months immediately preceding the first day of the initial period or financial year and is authorised for the purposes of the Financial Services and Markets Act 2000 to effect and carry out contracts of home insurance on the first day of the initial period or financial year, or

(b) is a member of the Society (within the meaning of the Lloyds Act 1982) and, as such a member -

(i) effected, or was party to an agreement to effect, any contract of home insurance at any time in the period of 12 months immediately preceding the first day of the initial period or financial year, and

(ii) intends to effect further contracts of insurance in the initial period or financial year;

and for the purposes of paragraph (b) an insurer who falls within paragraph (b)(i) shall be taken also to fall within paragraph (b)(ii) unless the contrary is shown by the insurer to the reasonable satisfaction of the FR Scheme administrator.

<u>GWP information collection and calculation</u>

16.10. We understand the levy calculation to work as follows, by way of example:

- The first instalment of the primary levy in 2015 will be determined by reference to:

  - 2014 GWP information, as specified in the regulations;

- 2013 GWP for all scheme members, if 2014 GWP is not available, (required under the membership agreement) and for those non-members who voluntarily provide this information;
- 2014 GWP for all others pursuant to the legislation, subject to delay (if any), whilst the relevant information is published.

- The subsequent three instalments of the primary levy will be determined by reference to 2014 GWP figures adjusted for the payment made in the first instalment.

16.11. As the formula as currently drafted depends on getting the total GWP absolutely right, we consider that provision is needed to enable recalculations and adjustments to be made to allow for adjustments and rectifying errors.

16.12. We suggest the regulations are amended to provide for the levy to be collected by such instalments and at such times as the FR Scheme Administrator thinks fit. This would provide Flood Re with more flexibility when requesting instalments. Whilst the membership agreement is likely to set out a prescribed timescale for instalments (likely also to be adopted for non-members), this would be easier to amend than a timescale fixed in legislation.

17. **Question 8: Do you agree with the approach as set out, of a regular review of the primary levy and premium limits (at least every five years or sooner as required (Y/N)? If no, what changes to this approach should we consider?**

17.1. We consider Regulation 25 should be amended to include provision for:

- The FR Scheme Administrator to take the initiative in producing a report (which is currently unclear);
- Imposing an explicit duty on the Secretary of State to consider amending the levy amount and the reinsurance premium limits (which we have been advised the current drafting does not do). This ties into the fact that levy and premium levels are meant to be adjusted as Flood Re's exposure to high risk properties develops, as part of the transition to risk-reflective prices and Flood Re's prudential management; and
- Requiring the Secretary of State to provide reasons to the Flood Re scheme administrator for not approving its recommendations. We are concerned that any recommendations will likely involve issues of prudential management, so Flood Re will need to understand the basis for not enacting them.

17.2. Flood Re does not have any objections in principle to a regular review of the levy and premium levels at least every five years or sooner as required, subject to:

- Relevant ministers having an appropriate degree of accountability to Parliament as a result of having the ultimate say on the levy amount and upper limit of reinsurance premiums set out in legislation (albeit after considering recommendations made by Flood Re); and,
- There being a prospect that any further 'top-up' capital contributions required in the interim are repayable at the discretion of directors and subject to the agreement of the PRA.

18. **Question 9: Do you agree that these are the right definitions for the purposes of the Scheme (Y/N)? If not what changes would you suggest?**

    18.1. See answer to Question 7.

19. **Question 10: Do you agree it is necessary to provide more detail on the definition of flood in the Scheme Document (Y/N)? If not, please give details of what should be changed on the approach taken for "flood"?**

    19.1. Since the regulations are including a definition of "flood", we consider this should be a definition which is clear. We endorse the more expansive definition detailed on page 17 of the consultation document, although do not have a view on whether this should be detailed in the Regulations or the designated Scheme Document, given this has the same effect (i.e. it would not be possible to change the definition in the Scheme Document unless the Regulations are changed).

    19.2. The more detailed definition of 'flood' explicitly excludes storm and escape of water. This will avoid any prospect of Flood Re having to pay out millions of pounds for these types of claims, contrary to policy intent, if Defra's wider definition is adopted and subsequently misconstrued. The broad definition will also cause uncertainty for insurers, who will want to minimise the risk of unexpected coverage disputes.

    19.3. The definition should also exclude rising damp or any other gradual seepage of water into a property by adding another criterion which requires water to enter the property *'with a volume, weight or force which is substantial and abnormal'.* This draws on leading insurance cases on 'flood', most recently *Tate Gallery v Duffy* [2007] EWBH 361, and targets the assistance of Flood Re to those instances where there is a sudden onset of water and the loss is suffered quickly, rather than the slow movement of water which can often be detected so that the loss threatened can be limited. We consider this would limit the scope for unnecessary legal disputes for Flood Re in the future. Furthermore, as gradual seepage is a common exclusion in insurance policies, the definition used for Flood Re should reflect this through its explicit exclusion.

    19.4. We would suggest the following amendments to the Scheme Document definition:

    (2) Subject to paragraph (3) "flood" means a body or movement of water from any source external to a property, which—

    (a) enters that property at or below ground level; and
    (b) does so with a volume, weight or force which is substantial and abnormal,

    and includes water which enters the property above ground level where part of the body of such water is at ground level, including as a wave rising from ground level or via a main, drain, sewer or pipe which is wholly or partly connected or adjacent to the property and is wholly or partly at or below ground level at the point nearest to the property.

(3) The following do not constitute flood—

(a) the gradual seepage or percolation of water into the property such as rising damp;
(b) rain water which enters the building before falling to ground level; and
(c) water escaping from a main, drain, sewer, pipe or other thing inside the building unless such escape was solely the consequence of a flood falling within paragraph (2).

19.5. We are still considering drafting issues around this definition to reflect policy intent and will approach Defra separately to discuss should this be necessary.

20. **Question 11: Do you agree that definitions for "buildings only policy", "contents" and "combined policy" are needed (Y/N)? If not, please explain why not.**

20.1. If the Government intends to set out the reinsurance premium limits in legislation as opposed to Flood Re's contractual documentation (which the Government has, to date, suggested is necessary), we have no objection to defining 'buildings only policy' or 'contents' in legislation since they will be required to identify the relevant reinsurance premium limit that applies for a relevant council tax band (or equivalent)**.**

20.2. We support setting out a non-exhaustive list of examples falling within 'buildings' and 'contents' so that Flood Re contractual documentation can deal with grey areas around what falls within these definitions that will inevitably surface.

21. **Question 12: The Government expects the Scheme to cover all of the areas set out in Box 4. Do you believe the Scheme should cover any other areas (Y/N)? If so, what would you wish to see?**

21.1. The Scheme Document is intended to remain fixed for the twenty-five year duration of the scheme. The Government therefore need to ensure that the Scheme Document is sufficiently flexible, where appropriate, for Flood Re to change its set-up without having to go through the parliamentary affirmative procedure (e.g. the levels of excess cannot be fixed since they will need to, at least, be altered from time to time in line with price changes).

21.2. Flood Re does not have any objections, in principle, to the areas identified by the Government to be detailed therein, subject to those details allowing for an appropriate degree of flexibility of operation. The Scheme Document will be publically available prior to designation.

21.3. For detail on corporate governance and accountability, we disagree with adopting an approach whereby the Scheme Document refers to specifics within contractual documentation or policies. Referring to these in a document designated in legislation would prevent changes being made without changes to the Regulations, which is impractical and disproportionate, given:

- Flood Re will be subject to statutory requirements set out in the Regulations once designated as the FR Scheme Administrator, regardless of the content of its corporate documentation;

- there will be transparency of operation, given important governance documentation will be publically available;
- Flood Re will be publically accountable to Parliament for its operation.

Additional Comments on Consultation Document and Draft Regulations

22. We have set out below further issues that we have noted, outside the specific questions asked by the Government, following a review of the consultation document and draft regulations:

23. **Initial Capitalisation**

23.1. The PRA will set an annual capital requirement for Flood Re based on their assessment of underwriting, credit, market and operational risk. To assess underwriting risk, Flood Re has to assess P&L impacts within a series of scenarios ranging from best to worst outcome. The PRA will require Flood Re to hold capital to meet claims and liabilities based on this modelling, plus an appropriate buffer likely to be in the region of 25-50%. The Board of Flood Re will also set an excess above this level depending on their risk appetite for ensuring regulatory requirements are met.

23.2. Flood Re will be capitalised under the existing ICA regulatory regime. Once Solvency II comes into force, its internal model will also need to be approved under that regime.

23.3. We do not yet know what the PRA will require for Flood Re's initial capitalisation. If the primary levy is not sufficient to capitalise Flood Re to the extent required by the PRA, the additional amount required over and above the £180m will be funded via capital contributions (from members) or additional levy (from non-members).

23.4. The Government should consider whether it would like to avoid a superfluous review once capital contributions reach £100m as part of this initial capitalisation and insert an additional clause into Regulation 26.

23.5. We would suggest the following wording: *Regulation 26(1) does not apply where the total net additional amount by way of contractual contributions requested by the FR Scheme administrator exceeds £100 million only in order to comply with any FSMA obligation relating to initial capitalisation.*

24. **FSMA Obligations**

24.1. We consider that an additional definition (and related clause) for 'FSMA obligation' would be beneficial to explicitly acknowledge that nothing in the regulations requires Flood Re to act contrary to its regulatory obligations. We would suggested the following additional clauses:

- A definition explaining that *"FSMA obligation" means any obligation to which the FR Scheme administrator is subject under or by virtue of the Financial Services and Markets Act 2000".*

- A 'general saving' clause for compatibility with regulatory requirements: *"nothing in these regulations shall require the FR*

Scheme administrator to act otherwise than in accordance with any FSMA Obligation".

24.2. Flood Re will need to be able to operate as an insurer in fulfilling its regulatory obligations and we are conscious that nothing in the legislation should prevent Flood Re from doing so, particularly in light of the proposed financial controls. This is linked to ensuring that accountability lines are clear i.e. to the PRA, responsible for solvency issues, versus the Government and Parliament.

25. **Commission**

25.1. Paragraph 47 of the consultation document states that commission would not be payable on premiums (*"it is the Government's intention that the savings associated with the effective limit on premiums will be passed on by insurers to policy holders. As such it is not expected that commissions should be payable on these amounts. This expectation will not be set out in regulations, but is part of the 2013 Memorandum of Understanding"*).

25.2. We do not agree that this expectation forms part of the MoU. This stated that the industry would ensure that *"the flood risk element"* of prices paid by consumers for a combined policy ceded to Flood Re would not exceed the limits stated therein. No reference is made to ancillary costs such as commission being removed.

25.3. There is no legal requirement in the regulations to not charge commission on the overall home insurance premium. This would cause significant difficulties for existing practices in the market and lead to distortion, since commission would usually be paid to brokers or other partners on the total premium for domestic buildings and/or contents policies (not specifically the flood risk element). Any commission savings will be a function of a competitive market on the overall home insurance premium.

25.4. Our main concerns, if this were to be made a legal requirement, are that:

- Brokers or partners may avoid providing a service for Flood Re customers, compressing the market and the opportunity for customers to shop around;
- Every insurer would have to separately identify the flood premium cost for each risk and remove the commission element from it before communicating price to the end customer. This would be significant additional cost to the insurance industry to implement systems and pricing model changes to ensure no customer is paying commission on their flood cover if ceded to Flood Re. This could act as a disincentive to insurers to use Flood Re.

Flood Re Limited

September 2014