Association of British Insurers 51 Gresham Street, London EC2V 7HQ Tel: 020 7600 3333 Fax: 020 7696 8999

Securing the Future Availability and Affordability of Home Insurance in Areas of Flood Risk

Response from the Association of British Insurers

The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 28% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed. Every day, our members pay out £147 million in benefits to pensioners and long-term savers as well as £60 million in general insurance claims.

The ABI

The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

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General Response

1 We welcome this consultation on the future of flood insurance. The UK has traditionally had an effective market for flood insurance, with cover provided as a standard component of home insurance policies. However increasing flood risk, combined with insurers' increasingly sophisticated and granular understanding of that risk threaten both the availability and affordability of flood insurance for up to 500k high flood risk homes. The continued availability of affordable flood cover brings peace of mind to hundreds of thousands of people throughout the UK living with the risk of flooding; alongside targeted investment in flood risk management and ensuring there is no inappropriate development in areas at risk of flooding, it is a crucial part of managing flood risk in the UK.

2 The insurance industry's proposal, Flood Re, is the only model that can deliver affordable flood insurance over the long term, without disproportionately distorting the wider home insurance market. It is the only model to have been developed that clearly focuses on affordability; by clearly setting and defining premium thresholds at a level deemed as affordable, it gives clarity on how much people will be charged for the flood portion of their premium, and means the approach is not subject to the assumptions and uncertainties created by using a single flood risk modelling and mapping approach. This is particularly important considering the as-yet immature nature of surface water flood risk mapping. By varying these premium thresholds according to council tax band, it also means that Flood Re is progressive, targeting support towards the households that need it the most.

3 The alternative Flood Insurance Obligation will not resolve the issue of affordability; instead, it will shift the issue onto other households. It will create a home insurance market that will be hugely confusing for customers, generating a situation in which those at highest risk could be able to access cover at a price significantly lower than those at lower risk. It will be uncertain for customers too, as insurers try to manage their portfolios to a defined target. A model which compels insurers to take on risks that are otherwise uninsurable is also contrary to the ethos of Solvency II and, ultimately, is likely to result in insurance companies leaving the UK market. It will be extremely unattractive to investors, with potentially very serious consequences. There appears to be no precedent for creating a market in which the providers are forced to sell a product to a subset of customers, and neither the UK Government nor Regulators have experience designing such a system. The approach is therefore extremely unlikely to be successful, involving a turbulent and uncertain transition period.

4 The ABI welcomes the fact that the Government has clearly stated Flood Re as the preferred option. It is an important first step in implementing Flood Re, and delivering the peace of mind needed by at least 200,000 households across the UK. However there is a lot of work still to be done to get Flood Re 'open for business', which will require significant effort from both the industry and Government.

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Responses to Consultation Questions

Question 1: Do you have any evidence of small businesses experiencing difficulty with the availability and affordability of property insurance due to the risk of flooding?

5 No. Affordable property insurance is currently widely available to small businesses in the UK. The insurance industry and Government have rightly prioritised the development of a model that delivers affordable flood insurance over the long term to domestic householders (Flood Re). Because the number of SMEs at high risk of flooding is relatively small compared to domestic households and due to the complexity of the commercial property insurance market relative to the domestic market, Flood Re as it has been developed is unlikely to provide the solution for SMEs.

6 Flooding is one of a number of perils covered by commercial property insurance and industry claims data shows that perils such as fire are much more costly to insurers. In 2012 damage from weather related events (both flood and storm) constituted 26% of commercial property claims, compared to fire which constituted 41% of claims. Commercial property insurance is also a more complex market with different distribution channels to the domestic property insurance market.

7 One of the key differences between the domestic and SME sectors is the prevalence of brokers in providing insurance to SMEs, with estimates suggesting that nearly three-quarters of UK SMEs use a broker to arrange their insurance. Brokers can play a powerful role in placing businesses with insurers, even if insurers view the policy as being too risky as a stand-alone risk. This relationship seems unlikely to change with the expiry of the Statement of Principles.

8 It is also important to note that there are a wide variety of businesses, in terms of both size and areas of activity, contained within the SME sector. Some businesses will have more resources than others to assess and mitigate risk or implement prevention measures. SMEs also differ from the domestic household in that they are often more able to move locations, particularly if they are renting the property, and therefore potentially avoid high-risk flood areas. We estimate that only 55% of SME policies provide buildings cover, which suggests that many SMEs rent their properties. This has implications for market dynamics.

9 These points do not mean that available and affordable flood cover is not a problem for some SMEs, and the ABI will continue to monitor the market and seek solutions that ensure cover remains widely available and affordable to small businesses in the long term. We should also note that there is a blurry boundary between domestic and commercial property insurance, including buy to let, landlords, home workers, B&Bs etc. We are working with our members and the Government to establish the treatment of these types of boundary case within Flood Re.

Question 2: Do you agree with the Government's policy objective for flood insurance?

10 Yes. The ABI is committed to a solution that offers accessible and affordable flood insurance for high-risk flood properties. The continued availability of affordable flood cover brings peace of mind to hundreds of thousands of people throughout the UK living with the risk of flooding; alongside targeted investment in flood risk management

and ensuring there is no inappropriate development in areas at risk of flooding, it is a crucial part of managing flood risk in the UK, and the best way of keeping flood insurance affordable in the long term.

11 We believe that Flood Re is the only model that can deliver affordable flood insurance over the long term and fulfil the Government's policy objective without disproportionately distorting the wider home insurance market.

Question 3: Do you agree with the approach taken to analysing the different potential solutions in the Impact Assessment?

12 Yes. In particular we appreciate the provision of ranges in the cost benefit analyses as there is a significant amount of uncertainty on a lot of the parameters of the various options being considered.

Question 4: Do you agree with the evidence presented in the Impact Assessment?

13 We believe that the Impact Assessment underestimates the implications of a free market on availability and affordability of property insurance (in particular Annex 3 from the Impact Assessment).

14 Domestic property insurance is a competitive market in the UK, however, given the large number of homes at significant flood risk earmarked for inclusion in Flood Re, the implications of a free market are likely to be more extensive than the Impact Assessment suggests. The assumption that new market opportunities would emerge for insurers and brokers who specialise in insurance for high flood risk properties is overstated.

15 In a free market high risk-related prices are likely to arise because insurers are unlikely to find high flood risk business particularly attractive, particularly given the increasing sophistication of insurers' understanding of flood risk, and will require a relatively high profit margin to induce them to take the risk. As Professor Stephen Diacon's Independent Review of Flood Insurance Analysis states, *"insurers may not have much of an appetite for high-risk properties, and the prices would need to be high to persuade them to offer cover. They may also be concerned that this risk may be under-priced. There is unlikely to be much competition in the market for such business."*

Question 5: Do you have any further evidence which has not been considered in the Impact Assessment?

16 No.

Question 6: Do you support the Government's proposed approach?

17 The ABI supports the Government's preferred option of the Flood Re model. It is the only model to have been developed that clearly focuses on affordability; by clearly setting and defining premium thresholds at a level deemed as affordable, it gives clarity on how much people will be charged for the flood portion of their premium, and means the approach is not subject to the assumptions and uncertainties created by using a single flood risk modelling and mapping approach.

18 We do not believe that the Flood Insurance Obligation option represents a viable alternative that will be acceptable to consumers, regulators or the market. The Flood

Insurance Obligation will not resolve the issue of affordability; instead, it will shift the issue elsewhere in the market and confuse customers. It is likely to result in a situation in which those at highest risk could be able to access cover at a price significantly lower than those at lower risk.

Question 7: 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?

19 Regulating for the availability of affordable home insurance in flood risk areas through the introduction of a Flood Insurance Obligation (FIO) would be an unprecedented step. The Government should think carefully about the effect on consumers, the effect on a competitive insurance market, the impact on the mortgage and housing markets and on UK PLC.

20 For consumers, the FIO would represent a confusing and disjointed approach to flood insurance, where premiums would be in a constant state of flux, an increasing number of moderate flood risk homes would struggle to access affordable cover, and high risk homes would find themselves pushed around the market as insurers managed their quotas each year.

21 A model which compels insurers to take on risks that they would otherwise choose not to is likely to result in insurance companies leaving the UK market; a reduction in competition that would inevitably increase prices. It would be extremely unattractive to investors, with potentially very severe market consequences. There also appears to be no precedent for creating a market in which the providers are forced to sell a product to a subset of customers, and is thus extremely unlikely to be successful, involving a turbulent and uncertain transition period.

Question 8: 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?

22 The ABI and insurers have considered a variety of options for targeting or grading support throughout the development of the framework. The most accurate measure would be household income, but because this varies regularly and is not simple to calculate the use of this measure would be administratively challenging and very difficult to police.

23 In this context, the key is to find a proxy for ‘ability to pay’ that can be placed in a simple dataset, doesn’t change regularly and does not rely on customer disclosure. Council Tax band is the best approach that meets these criteria. Moreover, Council Tax banding is an independently calculated categorisation tool (thereby not calculated by the insurance industry, the private sector or the customer) so is not open to abuse or manipulation.

24 In order for insurers to be able to use premium thresholds based on Council Tax band, it is vital that they are able to freely access Council Tax band data as soon as possible in order to assist with analysis in preparation for Flood Re. The Memorandum of Understanding sets out Government’s commitment to provide this dataset to the

industry, free of charge. For Flood Re to be workable in Wales, Northern Ireland and Scotland, Government should ensure that Council Tax (or similar) bands in those countries are indexed and incorporated into the dataset.

Question 9: 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?

25 We agree with the combined figures as indicative 'maximum amounts'. However there may be some work still to do to finalise them, in particular to ensure the appropriate ratio between buildings and contents thresholds.

Question 10: Do you agree that the following should be excluded from Flood Re:

- **Band H properties?**

26 Yes. It is important that the support provided by Flood Re is targeted towards those who are most likely to need it. We consider that the vast majority of households in Band H properties should be able to afford risk reflective premiums or to take action to reduce their flood risk.

- **New homes built after January 2009?**

27 Yes. Affordable insurance cannot be allowed to incentivise development in flood risk areas. The Statement of Principles agreement excludes homes built after January 2009 for this reason, and Flood Re should mirror this.

28 It is crucial that the planning system (both in terms of underlying policy and enforcement) is robust enough to ensure that there is no unwise development in flood risk areas in the future.

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

29 In principle, properties that flood very regularly should not be allowed access to subsidised insurance (at least until action has been taken to manage the flood risk). Such properties would have extremely high technical flood insurance premiums and would therefore be hugely subsidised by Flood Re, and may end up with a far better deal than they have had under the Statement of Principles. However in practice it may be challenging to develop a robust mechanism for identifying and excluding such homes.

Question 11: Should other exemptions also apply?

30 It is important to agree a position on the treatment of the Crown Dependencies, as home insurers typically write such business under their UK accounts, and will need to be clear on the treatment of such properties in good time.

Question 12: Do you agree that Flood Re should apply to both buildings and contents insurance?

31 Yes. Both buildings and contents insurance would be expected to create availability and affordability problems for high flood risk households in a free market. Furthermore,

for an insurer selling combined buildings and contents policies, the complexity around underwriting decisions would be significantly increased if only one part of the policy were able to be ceded to Flood Re. It is desirable to set the ratios between buildings and contents thresholds so that if a household's building policy is ceded to Flood Re, the contents policy is likely to be ceded as well, and *vice versa*.

Question 13: Do you have any comments on this proposed way of managing Flood Re's exposure to large losses?

32 The ABI has worked closely with Government on options for managing the potential liabilities created by the volatility of flood claims. We agree that Flood Re should not be responsible for liabilities to insurers when annual aggregate losses exceed a 1:200 level, and that Government should take 'primary responsibility' beyond this point.

33 More work remains to be done by insurers and Government to ensure that these arrangements are established in such a way that the solution has no additional capital requirements for the industry as a result of its implementation.

Question 14: 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?

34 Yes. The levy is a vital component of Flood Re, and is the fairest way to make sure that all insurers (and by implication all home insurance customers) contribute to the stable and affordable flood insurance system that is being delivered. Without a cross-subsidy set at this level, insurers will not support the establishment of Flood Re.

35 Fundamentally, the decision about whether it is right for those at lower risk to cross-subsidise those at high risk is a political decision for Government, but the ABI strongly advocates cross-subsidisation at this level, because the consequences of a lack of affordable cover in the market are significant, not just for high risk homes themselves but also for the communities in which they are situated and for local property markets.

Question 15: Do you agree that Flood Re will secure the availability and affordability of household flood insurance in the UK?

36 Yes. By clearly setting and defining premium thresholds at a level deemed as affordable, Flood Re will give clarity on how much people will be charged for the flood portion of their premium, and means the approach is not subject to the assumptions and uncertainties created by using a single flood risk modelling and mapping approach.

37 An insurer ceding a policy to Flood Re transfers both the risk and the premium income, meaning that the incentive for the insurer to decline cover because of the risk of flooding is removed. So Flood Re will open up the home insurance market to high risk households, giving them the opportunity to shop around and enjoy the benefits of a competitive market.

38 Furthermore, Flood Re is designed to be dynamic by allowing insurers to make their own judgements about whether they cede a flood policy to Flood Re or undercut the Flood Re premium threshold and keep it themselves. This dynamism will maintain incentives on individuals to manage their flood risk (as it could get them out of Flood Re

and paying a lower price). It also allows homes that are thought to be low risk now, but which turn out to be high risk in future, to be incorporated into the scheme easily.

Question 16: Do you agree that the Flood Insurance Obligation (FIO) has the potential to meet the policy objective?

39 No. There are many issues with the ‘FIO’ proposal that make it extremely unlikely to be successful in providing a sustainable market that provides available and affordable insurance for those customers at highest risk of flooding. Because of these issues, such an approach would be extremely unpalatable to the industry and unacceptable to consumers.

40 The proposal would be likely to increase the total cost base of the home insurance market, due to the paying of penalties for not meeting quotas and likely reduction in competition due to market withdrawals. The customer impact would be an overall increase in bills across the market. Compared to a free market or Flood Re, the FIO would also increase the amount of high flood risk business that most insurers would take on, hence increasing volatility and capital burden, and reducing profitability. This could impact on shareholder confidence, damaging the investibility of UK household insurers and destroying value in one of the UK’s leading sectors, which is a major employer, tax contributor and net exporter. Ultimately it could lead to some insurers leaving the UK home insurance market; a reduction in competition that would inevitably increase prices.

41 The FIO would rely on a single view of flood risk which would inevitably fail to match exactly with insurers’ views. The customer impact of this would be a dysfunctional and constantly changing market, and a strong likelihood that some high risk customers would end up with much cheaper insurance than many lower risk customers, with customers just outside the quota (i.e. a slightly lower risk than the quota threshold) experiencing difficulty accessing affordable cover. Some customers in the quota system could potentially become so attractive to insurers that their premiums could be competed down to zero.

42 The proposal may be inconsistent with principles enshrined in the European Convention of Human Rights, which protects businesses and individuals from interference with their property rights, with free movement principles of the Treaty of the Functioning of the European Union and with regulatory obligations set out in the Financial Services and Markets Act 2000 (FSMA). Given the very material likely impact on their investibility, it is highly likely insurers would seek to establish the legality of any Government legislation.

Association of British Insurers
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