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

Response by the Council of Mortgage Lenders to the Department for Environment, Food & Rural Affairs consultation paper

Introduction

1. The CML is the representative trade body for the first charge residential mortgage lending industry, which includes banks, building societies and specialist lenders. Our 112 members currently hold around 95% of the assets of the UK mortgage market. In addition to lending for home-ownership, the CML's members also lend to support the social housing and private rental markets. This response has been developed in consultation with our members.

2. We welcome the Government's announcement to proceed with the introduction of a new flood insurance model, Flood Re. We welcome the opportunity to respond to the DEFRA consultation on the development and introduction of this model, along with a fallback regulatory Flood Insurance Obligation. We believe these proposals represent a sensible way forward in the circumstances. This response focuses on aspects of the consultation that are relevant to mortgage lending. References to question numbers are references to those in the consultation paper.

Affordable flood insurance; mortgageability and housing market impacts

3. Whether delivered via Flood Re or the regulatory Obligation, it is important to keep in mind the implications for mortgageability and impacts on the housing market if affordable flood insurance ceases to be available or is less available than currently. These are the issues we have flagged previously:

4. For existing customers/ lending (back book):

- Cover may be allowed to lapse
- Customers may therefore be in breach of mortgage terms and conditions to insure at all times
- Lenders may not being aware that cover is not in place or is insufficient
- The potential for borrower default or arrears through financial stress of having to repair uninsured damage
- The potential risk to the lender of repossessing a flood-damaged property (the loss of loan security value; repair costs and impact on re-sale margin)
- Administrative/ process costs of checking borrowers have/ are maintaining suitable cover
- The possibility that regulators might require lenders to provide additional capital cover for uninsured mortgaged properties.

5. For new customers/ lending (front book):

- Having and maintaining buildings insurance (including for flood) is a standard condition of any mortgage. If flood cover was not available or too expensive (in terms of cost of premium or excesses), this could affect mortgage affordability calculations or loan-to-value (LTV) rates, suppressing housing market activity and potentially rendering some properties un-mortgageable and sellable only to cash buyers.

The government's policy objective (Question 2)

6. We agree with the policy objective to ensure domestic buildings insurance (including for flood) continues to be available and affordable. We would like to see more detail on how the limitations of Flood Re will impact customers in properties covered by the scheme.

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7. A key part of the government's objective is that the market will move gradually to fully risk-reflective pricing in the next 20-25 years. Although we agree with the intention to move to risk-reflective pricing, we believe that it is optimistic to expect this to be fully achieved in the timeframe proposed. The paper does not set out clearly how the move to risk-reflective pricing will happen. This is important for lenders to understand as mortgages will be being written for not only 25 year terms but also for 30-40 year terms. We do not want to be in a period of uncertainty again in the medium term if it is not clear how this is going to be moved forward.

The proposed solution: Flood Re, and transition to risk-reflective pricing (Q6&7)

8. We support in principle the government's proposed approach to introduce the Flood Re model along the lines indicated. We believe Flood Re could deliver affordable flood insurance premiums into the mid term in a way which targets the benefits of the scheme to those in greater need. Although we welcome the proposal to control excesses on flood insurance, we are concerned that there is no detail on how this will be achieved. Flood insurance excesses are a key part of affordability, and we do not want this to be overlooked. We would like to see clear details about how Flood Re will effectively control excesses as well as ensuring affordable premiums. If Flood Re can be delivered in time in this way, then we believe it should sufficiently address lenders' concerns which we had previously raised.

9. Flood Re is conditional on passage of the Water Bill, and on EU State Aid approval. These are considerable hurdles to overcome in time for a summer 2015 launch. We welcome the commitment that existing arrangements will be honoured under the Statement of Principles, until Flood Re is ready. However, the government and the insurance industry should recognise that this might be later than summer 2015.

10. We would like to see clarity up front about who will make the decision, and by what criteria, that Flood Re is not working or not delivering sufficiently to warrant moving to the fallback regulatory option. Linked to this is the need to have in place clearly defined and measurable performance criteria. If a move to the regulatory option is likely, factors to be considered should include:

- The treatment of mortgage properties already in Flood Re and how/ to what extent affordability can be protected during any move to a regulated market.
- The need to ensure that all mortgaged properties protected under Flood Re are captured by the Obligation. It is possible that some households might be missed in transition. This could bring back into play lender concerns about uninsured mortgaged properties.

11. **Eligibility for Flood Re support (Q8,9):** The use of council tax bands provides a practical, if simplistic, approach. It does mean, however, that the Flood Re model is founded on property value rather than entirely on risk. As council tax bands are pre-set, this removes an element of subjectivity and, as such, they could provide a practical means of exclusion assuming this information can be made available to insurance companies so that it can be incorporated in their underwriting models. The future of council tax in the Devolved Administrations will have to be kept under review to ensure that broadly the same eligibility thresholds apply nationally. The CPI uplift to the thresholds should be monitored to ensure the thresholds remain appropriate.

12. **Exclusions (Q10):** We are concerned about the exclusion of Band H properties. In the London/ South-East markets, there are many properties in Band H which could be excluded. It is simplistic to assume that households in higher value properties are wealthier and can easily afford higher insurance premiums/ excesses. Mortgaged owner occupiers of Band H properties are more likely to spend more of their household income on servicing their mortgage. For them, the affordability of insurance could be as much of an issue as for a household in a lower band property. The exclusion of Band H properties will result in regional bias in the properties covered by Flood Re and could have a blighting impact on high value properties in high risk postcodes. The proposed exclusion might adversely affect asset rich but cash poor households (e.g. elderly householders who purchased a property some years ago). We would like to see more detail on how it is intended the scheme would treat such households.

13. Excluding Band H properties would expose these households to free market pricing from summer 2015, with no soft landing. Lenders concerns about high premiums and excesses would

remain. These could cause mortgage affordability difficulties or loan-to-value limitations which could stifle mortgage and housing market activity in areas which are both high value and at higher flood risk.

14. We are also concerned about the exclusion of all new-build properties constructed since January 2009. Although planning changes should have meant that they were not constructed in flood-prone areas, we believe that these properties could still be at risk (within the timeframe for moving to risk-reflective pricing) as a result of climate change or increased and less predictable surface-water flooding. For properties in newer estates, lenders will have to take account of their exclusion from Flood Re in their underwriting affordability assessments. We recognise, however, that exclusion should encourage planning authorities and builders to consider more carefully the implications of developing in flood prone areas. We welcome this as it should mitigate against future escalation of the problem of inappropriate development.

15. **Types of policies; buildings and contents cover (Q12):** We believe Flood Re should extend to both buildings and contents cover. This will ensure affordability, and encourage uptake of suitable insurance policies in owner occupied and rented housing. In the private rented sector, where many landlords are funded by buy-to-let mortgages, affordable contents cover is important to the viability of the tenancy. Faced with an uninsured loss of contents, a tenant could fall into arrears of rent which could in turn impact the landlord's ability to sustain the buy-to-let mortgage.

16. **Managing Flood Re's exposure to large losses (Q13):** We welcome the intention that Flood Re will cover losses for policy holders in the pool up to the 1 in 200 year loss scenario (99.5% of years). However, we are concerned about what would happen in the event of a more extreme event. The paper suggests that the government would work with Flood Re and the insurance industry to decide how available resources should be distributed if this happened. If this means that claims would not be fully met then this is unacceptable, particularly for an event worse than a 1 in 200 loss scenario which would be potentially catastrophic. This could potentially impact the amount of capital a lender would need to hold against their back book. Would it not be possible for Flood Re to take out reinsurance for an extreme event, alongside reinsurance to cover against large claims in any one year? We recognise that there must ultimately be a limit on the resources of Flood Re. We would expect that government will be on-risk in an exceptionally extreme scenario.

17. **Funding; the annual levy (Q14):** An initial levy equivalent to £10.50 per UK household (based on an ABI estimate of the current cross-subsidy in the system) seems reasonable provided this figure does not rise further prior to implementation of Flood Re. A previous ABI estimate, given in evidence this year to the Environment Food and Rural Affairs Committee, was £8. We are concerned that the £10.50 figure might creep upwards. The intention to top-up any income shortfall with ad hoc payments from insurers seems optimistic, and should be strengthened.

18. Other general comments on Flood Re

- By the time of launch, there should be a clear definition of what events will be covered.
- The model should adapt to future climate change, and risk of surface water flooding.
- There should be greater clarity on how competition will be delivered under Flood Re

The flood insurance obligation

19. (Q16) The Obligation is less subtle, but also has the potential to meet the government's policy objective provided the required powers can be secured in legislation. We anticipate the legislation could be regarded as anti-competitive, which could present a serious obstacle to its passage. We have serious reservations about lack of competition under the proposed regulatory regime, which would be a great disincentive to investors. More work is needed to develop this approach.

20. (Q18) As with Flood Re, we believe the Obligation should apply to buildings and contents insurance. This would also maintain compatibility between Flood Re and the Obligation, if introduced.

21. **The role of the administrator; register of properties at high risk (Q19):** We do not see how the proposed register will work in practice. There will never be one single view of properties at

risk; as a result, some households will experience greater difficulty accessing affordable insurance. If introduced, we agree that the Environment Agency should be the lead administrator for compiling the register of each domestic property at high risk of flooding. We have concerns about the proposal to allow customers to opt-in or opt-out of registration:

- The register could blight properties as difficult to sell or mortgage
- There is a risk that householders might opt-out to conceal the fact that they are uninsured (this could include seeking to conceal a breach of their mortgage terms and conditions)
- There should be greater consideration of who should consent to inclusion or omission from the register (this could include the householder and/ or the mortgage lender)
- The register would have to keep up to date with changing risk, as identified by the administrator.

22. **The role and duties of the regulator (Q20):** We agree in principle with the role/ duties envisaged.

23. **Supervisory framework/ monitoring compliance (Q21):** We favour an audited regime which should provide transparency, independence and confidence for consumers and mortgage lenders. It would be less resource intensive than a fully regulated approach. We do not believe that a purely self-regulated administrative regime would be sufficiently open or robust to deliver confidence to consumers and other stakeholders including mortgage lenders.

24. **Enforcement framework/ sanctions (Q22):** We believe a hybrid regime could provide the most effective use of resources, while still providing a sufficiently certain/ consistent deterrent.

25. **Choice of regulator (Q23):** There should be full consideration of whether the FCA is the right choice of regulator for the FIO regime. In particular:

- whether delivering the FIO would be compatible with the FCA’s existing objectives
- whether delivering the FIO might conflict with the FCA’s responsibilities around mortgage affordability, given that insurance costs are considered in assessing this.

26. **Contact:** To discuss this submission further, please contact John.Marr@cml.org.uk

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