



Transitioning to an affordable market
for household flood insurance

The first Flood Re transition plan

February 2016

About Flood Re

Flood Re is a joint industry / Government sponsored scheme to:

- Enable flood cover to be affordable for those households at highest risk of flooding;
- Increase availability and choice of insurers for customers;
- Create a transitional measure to allow flood insurance to move towards risk-reflective pricing within 25 years; and
- Create a level playing field for new entrants and existing insurers in the UK home insurance market.

Flood Re's objective is to enable the continued availability of affordable flood cover for households at risk of flooding within one of the most competitive home insurance markets in the world, and manage a transition to a market with risk-reflective pricing over a 25-year period. It will do this by providing insurers with the ability to purchase subsidised reinsurance from Flood Re through a commercial arrangement.

About this report

As part of Flood Re's objective to transition to a market with risk-reflective pricing, it is required, within three months of being designated, to publish a plan outlining how it intends to manage that transition. It must then update that plan at least every five years. This report is Flood Re's first transition plan.

Further information

For further details about this publication or Flood Re, please visit www.floodre.co.uk or contact us by email: information@floodre.co.uk

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Foreword



Mark Hoban, Chairman – Flood Re

Flood Re has been established by the Government and the insurance industry to improve the availability and affordability of flood cover for people who live in high flood risk areas. When Flood Re launches in April this year, it will charge insurers a fixed premium based on council tax band and an excess on flood claims of £250. Flood Re also charges the insurers an annual levy of £180m. In effect, the levy subsidises the lower premiums and excesses as Flood Re will pay the claims on the households ceded to it by insurers. This should enable insurers to reduce the premiums and excesses that they currently charge their high flood risk customers.

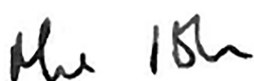
Flood Re has a fixed life of 25 years. By that point premiums and excesses for high flood risk properties should be priced to reflect the cost of flooding and households will lose the benefit that the levy provides of subsidising prices. Flood Re has a statutory duty to publish a transition plan that sets out how the market will return to risk-reflective pricing. The statutes setting up Flood Re do not explain what risk-reflective pricing means in practice. It could simply mean returning to the unaffordable premiums and excesses we see today. The Board of Flood Re does not believe that is the right outcome. We believe that the best outcome for high flood risk householders is that premiums and excesses remain lower than they are today in relative terms and that the levy, which subsidises both premiums and excesses, falls as the cost of flooding falls.

In practice this means that action must be taken to reduce the frequency and severity of flooding, that properties should become more resilient when flooding happens and that the cost of repairing flood damage falls. Because Flood Re has limited powers, we will foster strong relationships with Central and Local Government, the Devolved Administrations, insurers, consumer groups and others to encourage collective action to reduce the cost of flooding.

To reduce the frequency and severity of flooding, the Memorandum of Understanding between insurers and the Government establishing Flood Re committed the Government to £2.3 billion of flood defence investment up to 2021. We will use our database of high flood risk properties and work with others to identify where we believe that spending would be the most effective in cutting the cost of flooding to households and insurers. We will use that same database to highlight the changing nature of flood risk and how, therefore, spending could be prioritised to reduce the cost of that higher risk. We will also develop a strong evidence base on how to incentivise householders to take the most effective measures to protect their homes against flooding. As Flood Re will collect data on the cost of flood claims, we will be in a position with insurers and others to work out how to reduce the cost of repairs.

When Flood Re comes to an end, our preference is for householders to continue to benefit from more affordable insurance as a result of collective action taken to reduce the cost of flooding, rather than as a consequence of continuing subsidies.

This document, our first transition plan, sets out the initial steps that Flood Re will take in delivering our goal of enabling a move to affordable insurance for high flood risk households in the open market. We will produce updated versions of our plan as our knowledge of cutting the cost of flooding develops. Whether it is in our transition plans or in public debate or private engagement, Flood Re will stay true to its purpose of helping householders access affordable flood cover.

A handwritten signature in black ink, appearing to read 'Mark Hoban'.

Mark Hoban, Chairman – Flood Re

Outline plan

Background

Flood Re has been set up to improve the affordability and availability of flood insurance for residential properties at high risk of flooding. The legislation setting out the statutory basis for the scheme outlines that it will have a 25-year life. Over that time, Flood Re has the statutory objective to transition to a market with risk-reflective pricing. Its long-term goal is to ensure that the benefits of Flood Re, in terms of affordability and availability, are a long-term feature of the market even when the scheme is wound up. This would mean transitioning to a market with risk-reflective pricing where affordable household flood insurance is widely available.

For this to happen, the risks of flooding need to be managed and the cost of flood insurance claims reduced. This will require action from Central and Local Government, including the Devolved Administrations, insurers, households and a number of other parties. Flood Re will work with a wide range of stakeholders to support and promote this action.

Overview of Flood Re's transition plan commitments

This first transition plan outlines the expected course of the scheme's main parameters over the next five years:

- **Premium Thresholds:** From April 2017, Premium Thresholds will rise in line with the Consumer Prices Index;
- **Levy 1:** Is expected to remain at £180 million for the first five years of the scheme; and
- **Underwriting scope:** There are no plans to change the underwriting scope of the scheme or excess level.

Over the longer term, to achieve the Board's goal of transitioning to a risk-reflective market where household flood insurance is affordable and widely available, the risks of flooding and the costs of claims will need to be managed. Flood Re has an important role to play in both supporting the action that other parties need to take to do this and in ensuring that any action is guided by a firm evidence base. To do this, Flood Re will undertake three programmes of work in the coming months and years:

- **Understanding affordability and availability:** A programme of work to benchmark and track prices and availability of household flood insurance;
- **Incentivising action through Flood Re's data asset:** A programme of work to understand how Flood Re's data might be shared to help Government, the Devolved Administrations, Local Authorities and others (including the Environment Agency and the Committee on Climate Change) make decisions over the action needed to manage the risks and costs of flooding. This will consider how unintended consequences and issues like competition law and the privacy of personal data can be handled; and
- **Incentivising action from households and insurers:** A programme of work to provide the evidence base needed to understand how households and insurers can be supported to manage the risks of flooding and reduce the costs of claims.

In taking this work and its wider approach to transition forward, Flood Re is committed to seeking out and engaging a wide range of stakeholders. To help that process, Flood Re will constitute an advisory body. The next plan will report back on this work and will be published in time to inform the first of Flood Re's five-year reviews.

Executive summary

ES.1: Flooding and flood insurance in the UK

Flooding in the UK is a serious economic and social problem. Flood events in the North of England and Scotland in late 2015 and early 2016 demonstrate the devastating impact that flooding can have on individuals, households and communities. The Environment Agency suggest that over three and a half million residential properties in England and Wales are at risk from some form of flooding. Of these, around one in twelve are classed as being high risk.

For those households experiencing flooding, insurance can provide vital help at a time of crisis by helping them to manage the financial consequences they face. For all households and particularly those at risk of flooding, insurance provides a level of comfort that, should flooding occur, they are at least partially financially protected.

However, providing flood insurance is not straightforward and, if left to the private market, can be extremely expensive. As a result, a range of approaches have been adopted across the world to attempt to provide affordable cover. In the UK, a series of agreements between the insurance industry and Government have allowed flood cover to be included as part of a household's standard home insurance.

While this has made insurance available, affordability can be a problem as premiums and excesses can still be extremely high, despite an implicit subsidy provided from lower-risk households. This problem with affordability has been exacerbated by recent advances in flood risk mapping that have allowed insurers to make more accurate assessments of the risk profile of individual properties and, as a result, can lead to an increase in premiums for those judged to be at most risk.

For these, and a range of other reasons, the latest agreement (the 'Statement of Principles') between members of the Association of British Insurers (ABI) and Government expired in June 2013. Without another solution in place, estimates from the ABI suggested that at least 200,000 properties would have struggled to obtain affordable cover.

ES.2: Flood Re as a solution

These circumstances provided the backdrop to the creation of Flood Re. ABI members agreed to continue with the commitments of the Statement of Principles until Flood Re was in place. Following extensive public consultation and negotiation between the industry and Government, the Water Act 2014 and subsequent secondary legislation provided the statutory basis for the scheme.

Flood Re will make reinsurance for flood risk available to all insurers that underwrite home insurance policies in the UK. Its primary policy goal is to make flood insurance available and affordable for homes at high flood risk. The cost of reinsurance (the Inwards Reinsurance Premium paid by insurers to Flood Re) will be available at a fixed rate (the Premium Threshold) for each policy. This is set according to the council tax band associated with the property and provides a subsidy to the technical risk premium associated with high risk properties. Table ES.1 outlines the Premium Thresholds that will be in place when Flood Re launches.

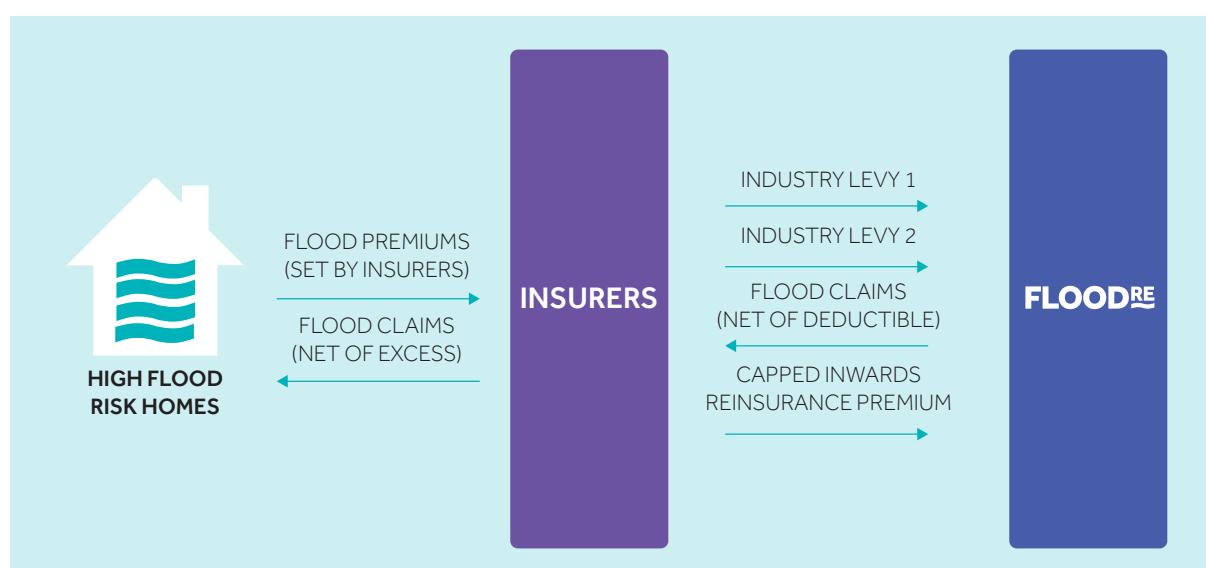
Table ES.1: Flood Re Premium Thresholds, 2016

Property tax band in England and Scotland	A	B	C	D	E	F	G	H
Property tax band in Wales	A&B	C	D	E	F	G	H	I
Flood Re category in Northern Ireland	1	2	3	4	5	6	7	8
Building only – net	£132	£132	£148	£168	£199	£260	£334	£800
Contents only – net	£78	£78	£98	£108	£131	£148	£206	£400
Combined – net	£210	£210	£246	£276	£330	£408	£540	£1200

To meet the costs of this subsidy, a levy (known as Levy 1) will be raised from all insurers writing home insurance in the UK. This will amount to £180 million a year for the first five years. The levy has a statutory basis and, as such, provides Flood Re with a certain income. It allows Flood Re to purchase reinsurance and build up a surplus of funds during average years so that it can withstand large loss events from time to time. If Levy 1 is not sufficient to meet requirements in any given year, Flood Re also has the ability to issue a compulsory call for additional funding from the industry through Levy 2.

Scenario testing has shown that Flood Re is a highly resilient model. It is designed to be robust to above a 1 in 200-year annual loss, providing up to £2.1 billion of cover through the global reinsurance market. Such a loss would be of a larger scale than anything seen in the last 100 years.

When Flood Re is in operation, customers will continue to buy home insurance from an insurer as they currently do. As now, the premium paid by the customer will continue to be set by the insurer. In the event of a claim, the customer will communicate with their insurer and Flood Re will reimburse insurers for the flood element of any claims. A standard deductible of £250 per policy for each claim will apply. As with the pricing of premiums, insurers will continue to set the excess that applies to a consumer's policy. Figure ES.1 outlines the basic principles of how the Flood Re scheme will operate.

Figure ES.1: Basic principles of Flood Re

Flood Re will become fully operational in April 2016. The size of the scheme is currently unknown as it will be for insurers to decide which policies they cede and it will take time for the market to respond fully.

While it is an industry-run, industry-led and industry-owned company, as well as being regulated by the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA), Flood Re also has direct accountability to Parliament for its achievement of the policy objectives set out in legislation, and for its custodianship of public money.

Transitioning over 25 years

Flood Re has been designed to provide temporary support to the insurance market for properties at high risk of flooding. At the end of 25 years from the date the Water Act 2014 received Royal Assent (May 2014), Flood Re will have been wound up and the subsidy provided through the scheme removed. A market with risk-reflective pricing should then be in place.

There are a number of reasons why it is desirable to move to a market with risk-reflective pricing. As with the Statement of Principles, to ensure affordability, Flood Re will continue to rely on a cross subsidy from those with little risk of flooding. Flood Re also introduces operational costs that an open market would not incur. In the longer term continued subsidised pricing could reduce the incentive for the Government, insurers and households to take the necessary steps to reduce the risks and costs of flooding.

Overall, these market distortions mean that an insurance market with risk-reflective pricing for household flood risk would provide a more efficient solution and offer the potential for better outcomes for households at significant risk of flooding and those with low risks of flooding.

To achieve this transition, between now and 2039, Flood Re will seek to reduce the subsidy provided through the scheme and the associated industry levy. Doing this over 25 years will allow time for a range of parties to take the necessary steps to ensure that an affordable market is created by managing both the risk and costs of flooding.

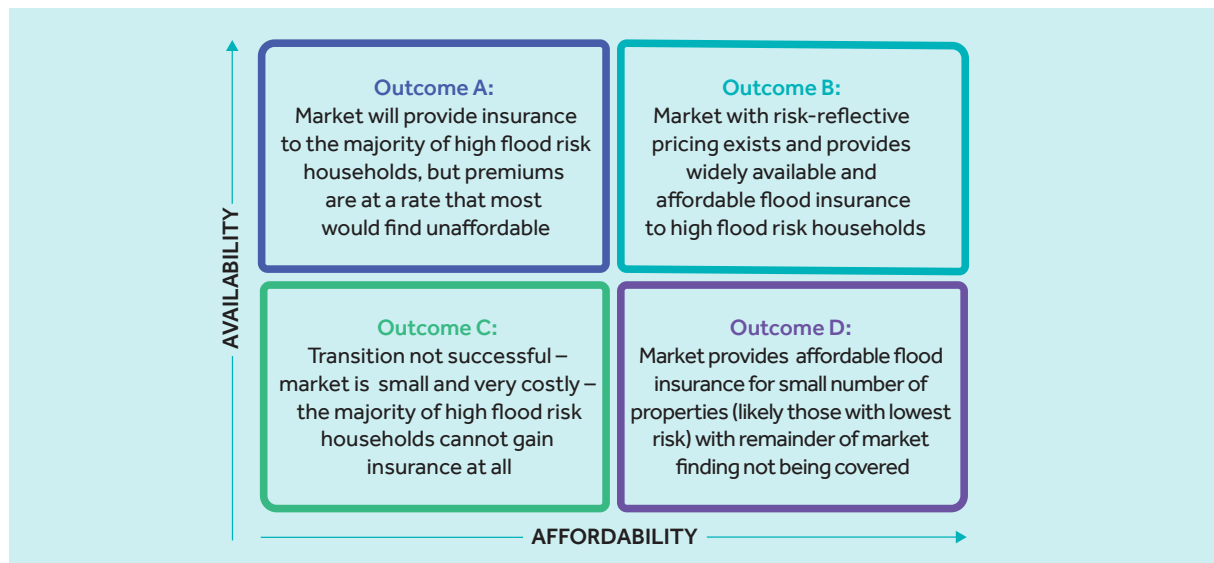
Flood Re is required to produce a plan to outline how it will approach transition. The legislation requires that Flood Re publishes its first transition plan within three months of being designated and then at least every five years following that. This report is the first of those plans.

Scope of the transition plans

The regulations providing the legislative basis for Flood Re outline the requirements of Flood Re's approach to transitioning. In straightforward terms, the regulations state that the goal of transition is to reach a market where household flood insurance is available in a market with risk-reflective pricing. This could be achieved by reducing the subsidy provided through the scheme so that the gap between the inwards reinsurance premiums paid by insurers and the true underlying technical risk cost, reduces to zero over time. For this to happen smoothly, at the point of transition, Levy 1 should have been removed and Premium Thresholds should reflect the underlying technical risk cost.

However, as the regulations do not say anything about the affordability or availability of household flood insurance, achieving transition along these lines is compatible with a range of different outcomes for households in high flood risk areas. For example, Flood Re could achieve transition as set out in the regulations but the market could prove to be unaffordable for the majority of households.

Figure ES.2 outlines potential outcomes from a successful transition to a risk-reflective market in terms of affordability and availability. Only outcome B is consistent with transitioning to a market that is affordable for those who need it.

Figure ES.2: Potential market outcomes from transition to risk-reflective pricing

With this in mind, in considering its approach to transition, Flood Re's Board of Directors believe that successful transition will rest on whether, once the subsidy associated with the scheme has been removed, household insurance for properties at risk of flooding is both available and affordable.

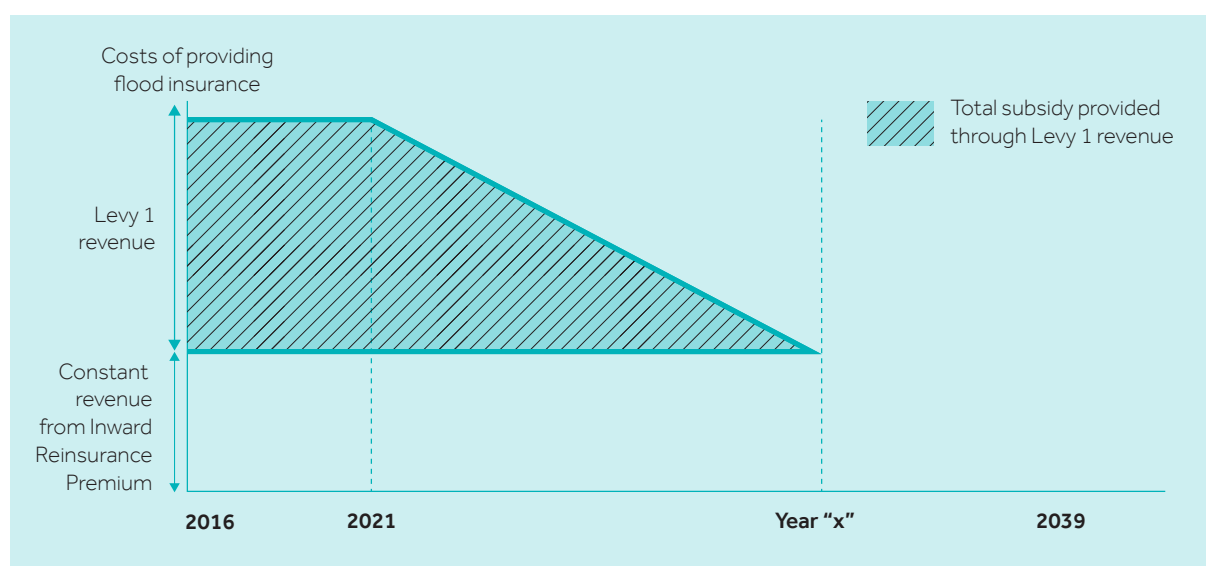
ES.3: Transitioning to an affordable market with risk-reflective pricing

Affordability will mean very different things to different households, communities and interest groups. It is also a concept that will vary both over time and between generations as household incomes change and preferences and attitudes towards risk evolve.

However, whatever the baseline, anything that reduces the costs of providing flood insurance (and therefore premiums) will improve affordability. Within this context, it is clear that transitioning to an affordable market along the lines of outcome B will require that the cost of providing flood insurance is reduced over time.

Figure ES.3 outlines this situation. It shows Levy 1 being phased out so that, by "year x", 100% of Flood Re's income comes from the Inwards Reinsurance Premiums (as determined by the level of the Premium Thresholds and the number of policies ceded to Flood Re). The reduction in Levy 1 revenue is offset by reduced costs of providing flood insurance and, as such, Premium Thresholds are allowed to remain constant in real terms over time.

Figure ES.3: Illustrative and simplified example of phasing out the subsidy provided through Flood Re



Reducing the costs of providing household flood insurance will require an understanding of both what drives these costs and the tools that might be used to reduce them. In broad terms, in a private market, these can be summarised as:

- **The risk of flooding:** Higher risks are associated with higher costs. Risks depend on factors like climate change; the development and maintenance of flood defences; community and property level resistance action; and planning decisions;
- **The costs of claims:** Higher average claims lead to higher costs. Costs of claims are associated with drying out and cleaning flooded properties; repairing flood damage; and re-housing residents while repairs take place. A range of factors can influence these costs, including the installation of property level resilience and resistance measures, the actions taken by at-risk communities and insurers' approach to repair; and
- **Competition in the market:** A greater level of competition is associated with lower costs. The introduction of Flood Re should increase competition. In the longer term, the level of competition will also depend on the willingness and ability of households to actively engage in the market.

With this in mind, it is clear that the majority of the actions that will need to be taken to reduce the costs of providing insurance are not under the direct influence of Flood Re. For instance, Flood Re does not control decisions over flood defence investment and maintenance; insurers' pricing; the behaviour of households; building regulations and choice of location for new development; or policy on climate change and adaptation. This means that, alongside Flood Re's approach to transition, others will need to take action if an affordable market is to be achieved.

As an advocate, convener and source of data and research on the risks and costs of flooding, Flood Re can play an important role in supporting this action and ensuring that it is built upon a strong evidence base. Table ES.4 provides examples of where Flood Re might be able to take action to support others in managing the risks and costs of providing flood insurance.

Table ES.4: Examples of the role that Flood Re could play in helping to reduce the costs of providing flood insurance

Insurance cost driver	Flood Re's potential role		
	Direct lever	Indirect lever	Role in supporting action of others
Risk of flooding			
Likelihood of flood events	No	No	Yes. For example, through use of its data to guide investment in flood defences
Likelihood of a given household flooding	No	Yes. For example, through the information it provides on steps householders might take to protect their property	Yes. For example, through building understanding of the impacts of property level resistance measures
Costs of flood claims			
Severity of flood event	No	No	Yes. For example, through use of its data to guide investment in flood defences
Cost of repair (including re-housing)	No	Yes. For example, through the information it provides on steps householders might take to protect their property	Yes. For example, through increasing understanding of the impacts of property level resistance and resilience measures. Also through the data it holds on claims costs
Administration	No	No	No
Competition in the market			
Number of firms	No	Yes. The creation of Flood Re should encourage new entrants into the market	—
Consumer engagement	No	Yes. The creation of Flood Re should increase engagement by giving households more choice over their household flood insurance provider	—

Flood Re has also already committed to taking steps to consider, within its first two years of operation, what role may be appropriate for it to play with regard to incentivising households and insurers to implement property level measures. Any potential actions will need to be substantiated by a strong evidence base and implemented with regulatory approval and support from Government, industry and stakeholders including consumer representatives.

ES.4: The first plan – scheme parameters

With Flood Re due to be fully operational in April, this transition plan does not have the benefit of all the data that will be needed to plan for transition. This makes it impossible for this first plan to outline a comprehensive description of the way in which Flood Re will reduce the subsidy provided through the scheme over the next 23 years. However, this report does provide an indication of how Flood Re plans to approach transition in future and how it might respond to other changes in the market, within its existing powers.

Premium Thresholds and Levy 1: next five years

As set out in statute, at the start of each financial year (from 1st April 2017) the Premium Thresholds will each rise in line with the Consumer Prices Index (CPI).

Based on the Premium Thresholds rising by the forecast level of CPI over the next five years, the expectation is that Levy 1 will be fixed at £180 million over that period.

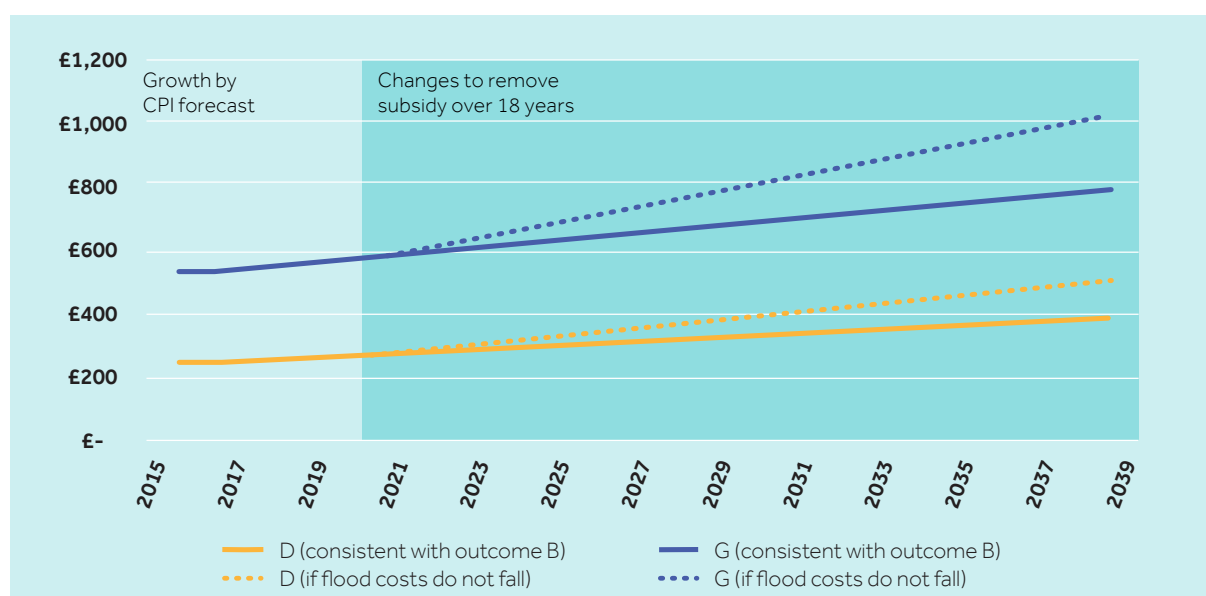
Premium Thresholds and Levy 1: indicative longer term changes

The path of Premium Thresholds and Levy 1 over the longer term will depend on a range of, as yet unknown, factors such as the number of policies ceded to the scheme and how the risks and costs of flooding change. As such, they are not outlined in this first plan.

However, figure ES.4 demonstrates the importance of both the action that others need to take and the supporting role Flood Re can play in managing the risks and costs of flooding. As an example, it shows that, if the costs of providing flood insurance fall over time, Premium Thresholds for band D and G properties could be held constant in real terms (by increasing in line with inflation - represented by solid lines), as the reduction in Levy 1 is offset by reduced costs of providing insurance. This would be consistent with outcome B.

If action to manage the risks and costs of flooding does not take place, to remove the subsidy from the scheme, Premium Thresholds would need to rise by more than inflation (represented by dotted lines) and the result would not be consistent with outcome B.

Figure ES.4: Indicative potential changes to Premium Thresholds for council tax bands D and G



Future transition plans will provide more detail on potential future changes in Premium Thresholds and may also consider how and whether Premium Thresholds should change in such a way as to either attempt to increase penetration or phase out the subsidy provided through the scheme more quickly for those households better able to afford the move to a risk-reflective price.

Underwriting scope and excess levels: next five years

Reflecting the current lack of data on policies ceded to the scheme, there are no plans to seek to alter the underwriting scope or excess levels of the scheme. The 2009 cut-off for eligibility for properties to be ceded to the scheme will be in place when Flood Re comes into operation.

Underwriting scope and excess levels: longer term

In future, transition plans will have the ability to recommend and, with agreement of the Government and industry and subsequent legislation, implement changes to the underwriting scope and levels of excess. A wide range of approaches could be considered. However, any proposed changes will need to be built on a firm evidence base that shows how they will contribute to the transition to an affordable and risk-reflective market consistent with outcome B.

ES.5: The first plan - wider steps to support transition

As outlined in section ES.3, moving to an affordable risk-reflective market will require that the revenue impact of reducing the subsidy provided through Levy 1 is offset by reductions in the cost of providing insurance. This plan outlines steps that Flood Re will take to build the evidence base and work in partnership with other parties to support this.

Understanding affordability and availability

Flood Re has commissioned a study that will create a benchmark of prices and availability of insurance for households at high risk of flooding. This will be repeated regularly over the course of Flood Re's life. This work will complement the work already done by Defra and will consider how prices and availability vary by different household characteristics (e.g. council tax band).

To complement this benchmarking and monitoring, Flood Re will also undertake analysis to understand whether, in the absence of the Flood Re scheme, an affordable market could exist.

Incentivising action through Flood Re's data asset

Once up and running, based on the policies ceded to it, Flood Re will hold the most complete map of high flood risk homes. As floods occur, it will also have a complete picture of which of these properties are flooded, the associated cost of claims and how the costs of claims are made up (e.g. splits between repair and accommodation costs).

This will be an invaluable data asset. As well as guiding Flood Re's approach to transition, analysis of these data could be used to inform action from Central and Local Government, households and industry.

For instance, the data could be used by Central and Local Government and the Devolved Administrations to better understand the changing risk of flooding and to assess the effectiveness of existing flood defences. In turn, this understanding could then be used to determine where future investment in flood defences would have the greatest impact. Others, including the Environment Agency and the Committee on Climate Change could use the data to improve their own understanding and modelling of changing flood risks and the potential need for mitigating action.

There is, therefore, an apparent public interest case for opening these data up. However, there are also risks of unintended consequences (for example reducing the incentive for insurers to invest in developing more sophisticated flood mapping) and issues surrounding the use of personal data, competition law and intellectual property that will need to be addressed.

To ensure that the most is made of this data asset:

- Flood Re will undertake work to understand whether and how the data it collects on flood risks and costs might be shared to support the transition to an affordable risk-reflective market; and
- This work will take into consideration factors such as the privacy of personal data, competition law and the ownership of intellectual property. It will outline a set of guiding principles for how Flood Re can share this data with others, including Government, the Devolved Administrations, Local Authorities and non-departmental bodies, academia and wider stakeholders including industry. A full range of stakeholders will be brought into this work.

Incentivising action from households and insurers

Flood Re will take forward a programme of work to understand whether and how it might support and incentivise households and insurers to bring the costs of flood insurance down. This will include consideration of property and community level measures where there is a value-for-money case for doing so. To do this:

- Flood Re will actively seek out a wide range of stakeholders and look to build strong partnerships to take this work forward. This will include, amongst others, Central and Local Government, non-departmental bodies, flood experts, household representatives, experts in behavioural science and representatives from industries including insurance and flood protection;
- The work will include consideration of:
 1. How insurers might be supported to bring the costs of repair down;
 2. The evidence surrounding the impacts of property and community level interventions, gaps that exist in the level or quality of knowledge and how they might be filled, including the role that Flood Re can play;
 3. Evidence on the existing barriers to take-up and how householders can be incentivised to take action where there is evidence that it would prove worthwhile; and
 4. The role that Flood Re might play in prompting this action from households, insurers and others to boost the take-up of property level resistance and resilience measures.
- Flood Re will look to provide updates as information becomes available and will report back in its next transition plan; and
- As part of this work, Flood Re will both consider how best to track household understanding of these issues and work with the industry to explore the feasibility of beginning to collect data on resilience measures taken by households with policies ceded to the scheme.

Next steps

To support the commitment to engage with a wide range of stakeholders, Flood Re will create an advisory body to support its work in this area. Further details including the terms of reference will be provided in due course. The next transition plan will report back on this work and will be published in time to inform the first of Flood Re's five-year reviews.

Chapter 1:

Background to Flood Re

1.1: Flooding and flood insurance in the UK

Flood events in the UK

Flood events in the North of England and Scotland in late 2015 and early 2016 demonstrate the potential impact of flooding on households across the UK. It will take time for a fully accurate picture of the impact to emerge, but thousands of homes have been flooded and many of the families affected have needed to find temporary accommodation. Tens of thousands of homes were impacted in other ways. Previous events paint a similar story, with 7,700 homes affected by flooding in the 2013/14 winter and close to 43,000 flood-related household insurance claims being made in the summer 2007 floods alone.ⁱ

Table 1 shows estimates from the Environment Agency that suggest 1.85 million residential properties are currently at risk of flooding from rivers and the sea and 2.4 million are at risk from surface water flooding. Accounting for those properties at risk from both, these figures suggest that a total of over three and a half million residential properties in England and Wales are at risk from some form of flooding. Of these, around one in twelve are at high risk of flooding.ⁱⁱ

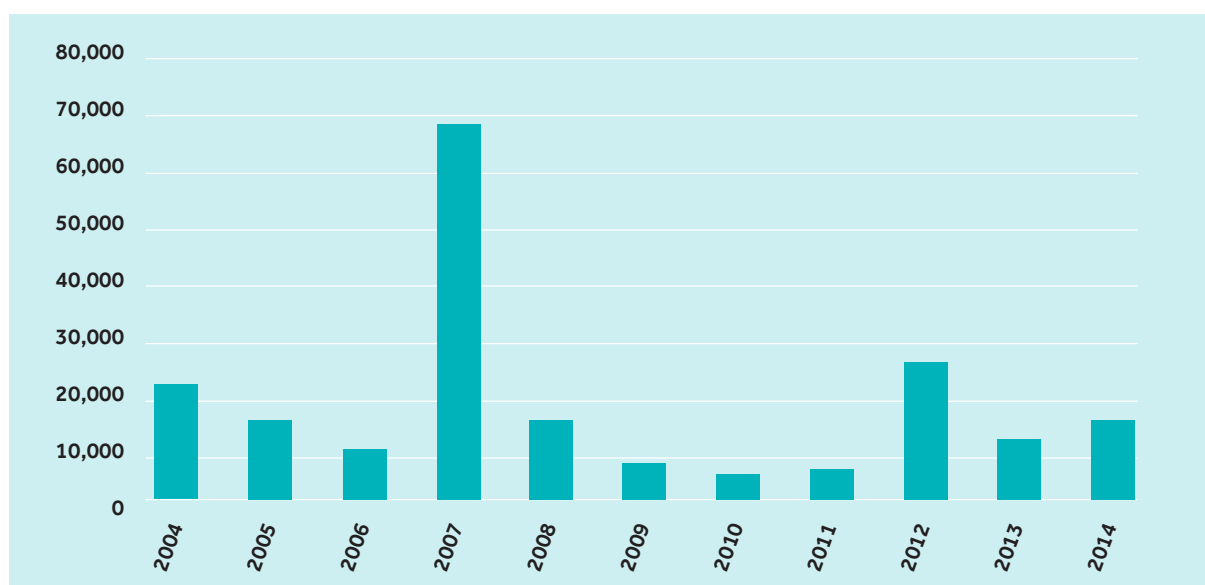
Table 1: Residential properties at risk of flooding.

Risk level	Rivers and the sea ⁱ	Surface water ⁱⁱ
High	153,000	209,000
Medium	350,000	388,000
Low	1,274,000	1,809,000
Very low	72,000	Not assessed
Total	1,849,000	2,406,000

ⁱ From the National Flood Risk Assessment

ⁱⁱ From flood map for surface water

However, even these estimates do not capture the full extent of the potential impact and spread of flood events in the UK. Figure 1 shows the number of household insurance claims related to flooding in the UK since 2004 and demonstrates the large variation in numbers from year to year.

Figure 1: Number of flood-related household insurance claims, by year

Source: ABI

These figures highlight the unpredictability of these events and the volatility of flood related claims. This is seen both in terms of the total number of properties flooded and location of individual properties that are affected. For the latter, a key example is the summer 2007 floods where around two thirds of the 43,000 residential properties that were impacted were not previously found on any maps of flood risk.ⁱⁱⁱ

Alongside the unpredictability and volatility highlighted above, other research has suggested that a combination of climate change and development in flood prone areas could be leading to the risk of flooding across the UK rising. These studies also suggest that it may continue to rise in the future. Estimates vary and are subject to significant uncertainty. However, the impacts could be large, with one study suggesting that 45,000 more homes could enter the highest flood risk category by 2060.^{iv} This means that flooding in the UK is a large scale and volatile issue that could occur with increasing frequency in the future.

The impact of flood events

The most recent flood events underline the devastating impact that flooding can have on individuals, households and communities. As well as the obvious financial impact on householders' properties and possessions, flooding can leave householders out of their homes in temporary accommodation for months while their home is repaired and dried out; destroy sentimental items; lead to significant emotional strain; and in the extreme, lead to loss of life; the 2007 floods were linked to 14 fatalities.

The wider economic effects also need considering. In the floods of the last few months, tens of thousands of homes were affected by power cuts and the impacts run much wider with transport infrastructure and public services all severely impacted by the flooding. Assessments by the emergency services suggested that the 2007 floods caused the greatest number of search and rescue missions since the Second World War.^v Based on the expected risks, the Environment Agency estimates the economic consequences of flooding to be well over £1 billion a year.^{vi} This figure would clearly be much larger in years with large flood events and the unquantifiable social and personal costs run much deeper.

The role of household insurance

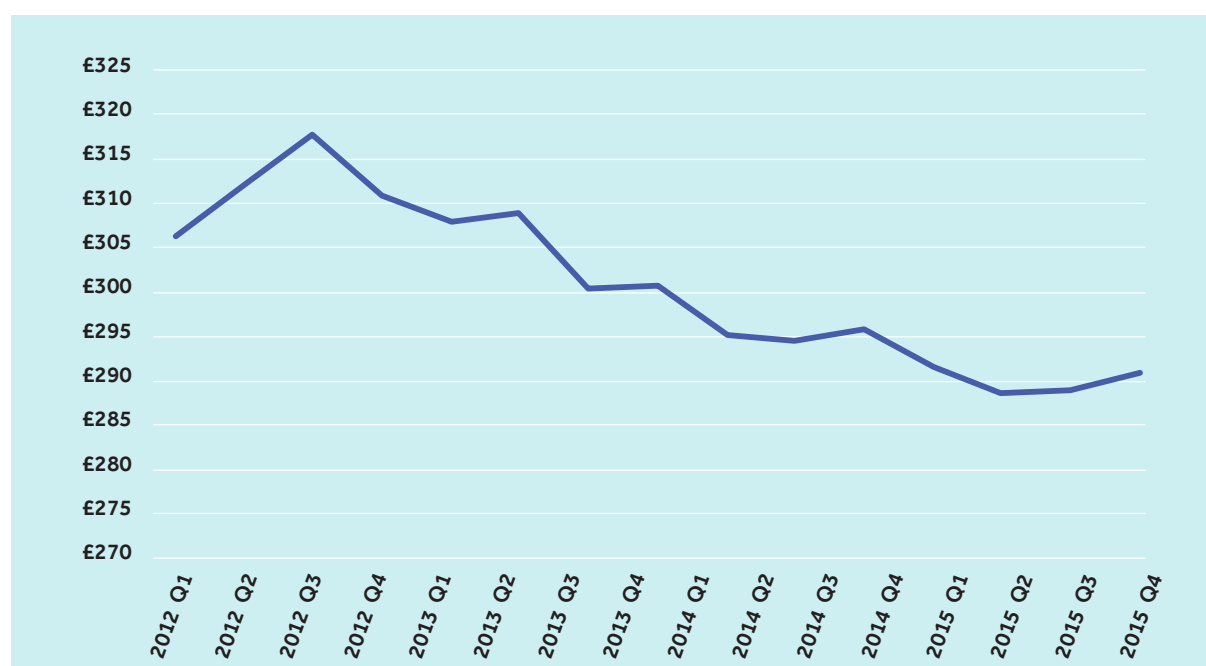
For those households experiencing flooding, insurance can provide vital help at a time of crisis by helping them to manage the financial consequences they face. For all households and particularly those at risk of flooding, insurance provides a level of comfort that, should flooding occur, they are at least partially financially protected.

However, the issues highlighted above mean that providing flood insurance is not straightforward and, if left to the private market, can be extremely expensive. To address this, a number of different approaches have been adopted across the world in an attempt to ensure that affordable insurance is available to those who need it. These range from compulsory cover by law to obligatory pool schemes where the Government acts as insurer of last resort.^{vii} However, in the UK, unlike in other countries, flood cover has typically been included as part of a household's standard home insurance. This has been made possible through the existence of a series of agreements between the insurance industry and Government since the 1960s.^{viii} The latest of these agreements, between members of the Association of British Insurers (ABI) and Government, formed the Statement of Principles that was adopted in 2000 and most recently renewed in 2008. This has ensured that, for the vast majority of households, insurance for their property against flooding has been available.

Since mortgage lenders in the UK require their customers to have buildings protection which includes cover for flooding and other perils for the property, it is no surprise that take-up of insurance is as high as 98% for homeowners. Coverage of households at-risk of flooding is similar to that of those not in risk areas. Take-up for renters is lower, with around 50% of these households having insurance, but take-up in at risk areas is higher at 55% (compared to 46% in non-flood risk areas).^{ix} ABI data shows that some 20.2 million household insurance policies were written in 2014.

Across all written policies in 2015, average premiums stood at £290 for combined (building and contents) policies.^x As figure 2 shows, average premiums have been falling in recent years.

Figure 2: Average premium for combined buildings and contents insurance



Source: ABI

1.2: The need for a new solution

While insurance has been available and average household premiums have been falling, the Statement of Principles was not designed to ensure affordability for all. Premiums for households at risk of flooding can be extremely high. It is difficult to generalise, but the British Insurance Brokers' Association (BIBA) has suggested that properties in a flood risk area might typically pay around 25% more than the equivalent property not in a high risk area.^{xi} Prices can also be much higher than this, with some households having to pay thousands of pounds a year for cover. The excesses associated with claims can also be extremely high. For instance, it is not unknown for excesses to be as high as £5,000 (or more) per claim for properties in high flood risk areas.

There were also a number of wider concerns with the Statement of Principles. For instance, that it did nothing to improve consumers' choice of cover for flood risks; that cross-subsidies were required to make it feasible; and that, because of this, incumbent providers in the home insurance market were at a competitive disadvantage because new entrants were not bound by the commitments of the Statement of Principles.

For these reasons, the 2008 update of the Statement of Principles made it clear both that the agreement would expire in June 2013 and that the Principles would not be renewed at this point.

This situation had significant potential implications for the availability and affordability of insurance for those at risk of flooding. ABI estimates from 2012 suggested that at least 200,000 properties would struggle to obtain affordable cover following the expiration of the Statement of Principles. The challenge for affordability was that ABI estimates showed that 78% of homes in areas of significant flood risk were receiving an implicit subsidy from higher-than-needed premiums paid by households in low flood risk areas. Research by the ABI and Oxera, carried out before Flood Re was developed, suggested an average under-pricing of around £430 for those at risk of flood, with one in seven being under-priced by over £1,500.^{xii}

The end of the voluntary agreement between the ABI and Government would have signalled the removal of this implicit subsidy. Given the size of the subsidy in place and with evidence from research showing that many households would struggle even with relatively small increases in premiums, this had the potential to severely reduce affordability.^{xiii} Intuitively, this would have been particularly true for lower income and vulnerable households and communities who might be less able to afford the potential rise in premiums and could be left uninsured.

Other changes across the insurance industry have also increased prices for those at risk of flooding and are likely to continue to do so. For example, recent years have seen an improvement in the ability to identify (albeit with varying levels of confidence) the geographic areas that are most at risk of flooding. This brings distinct benefits, including giving homeowners the knowledge they need to be able to prepare more effectively and allowing flood defences to be built in the places that need them most. However, an improvement in insurers' ability to assess the risks of flooding for specific geographic areas has also meant that households at risk of flooding are more likely than ever to be charged a much higher price (either through the premium or through a higher excess) than if they were not judged to be at risk of flooding.

Recent media coverage has highlighted the potential impacts. One extreme situation saw a yearly premium rise from £301 to £4,380 following the insurer's use of "...new flood information that predicts the risk of groundwater and flash-flooding".^{xiv} Other case studies show smaller impacts

on premiums, but significant rises in the excesses associated with claims. While anecdotal, these examples provide an idea of the potential impacts. In particular, rises in premiums and excesses of this level could have significant impacts on affordability (and potentially take-up) of insurance.

Flood Re as a solution

The expiration of the Statement of Principles and the advances in flood mapping, combined with the rising risks of flooding highlighted above, meant that the availability and affordability of household flood insurance looked likely to become a widening and deepening economic and social problem.

This situation provided the backdrop to the creation of Flood Re. Following extensive public consultation and negotiation between the industry and Government, the Water Act 2014 and subsequent secondary legislation provided the statutory basis for Flood Re to be created.

When in operation, Flood Re will make reinsurance for flood risk available to all insurers that underwrite home insurance policies in the UK, with the primary policy goal of making flood insurance available and affordable for homes at high flood risk. The cost of reinsurance (the Inwards Reinsurance Premium paid by insurers to Flood Re) will be available at a fixed rate (the Premium Threshold) for each policy, according to the council tax band associated with the property. Table 2 outlines the Premium Thresholds that will be in place when Flood Re launches.

Table 2: Flood Re Premium Thresholds, 2016

Property tax band in England and Scotland	A	B	C	D	E	F	G	H
Property tax band in Wales	A&B	C	D	E	F	G	H	I
Flood Re category in Northern Ireland	1	2	3	4	5	6	7	8
Building only – net	£132	£132	£148	£168	£199	£260	£334	£800
Contents only – net	£78	£78	£98	£108	£131	£148	£206	£400
Combined – net	£210	£210	£246	£276	£330	£408	£540	£1200

The Premium Thresholds have been set at a level that:

- Is below the level that would be charged for properties with the highest risk if prices fully reflected those risks. This provides a subsidy for those properties judged to be at risk and improves affordability; and
- Is still sufficiently high to ensure that insurers only cede those properties at high risk. This ensures that the industry retains a significant portion of household flood risk that can affordably and profitably be covered in the open market.

When Flood Re is in operation, customers will continue to buy home insurance from an insurer as they currently do. As now, premiums paid by the customer and terms of cover will continue to be set by the insurer. It will be for insurers to decide which policies they cede to the Flood Re scheme. Overall this means that customers will not deal directly with Flood Re and insurance companies will continue to set the premiums that they charge the customer.

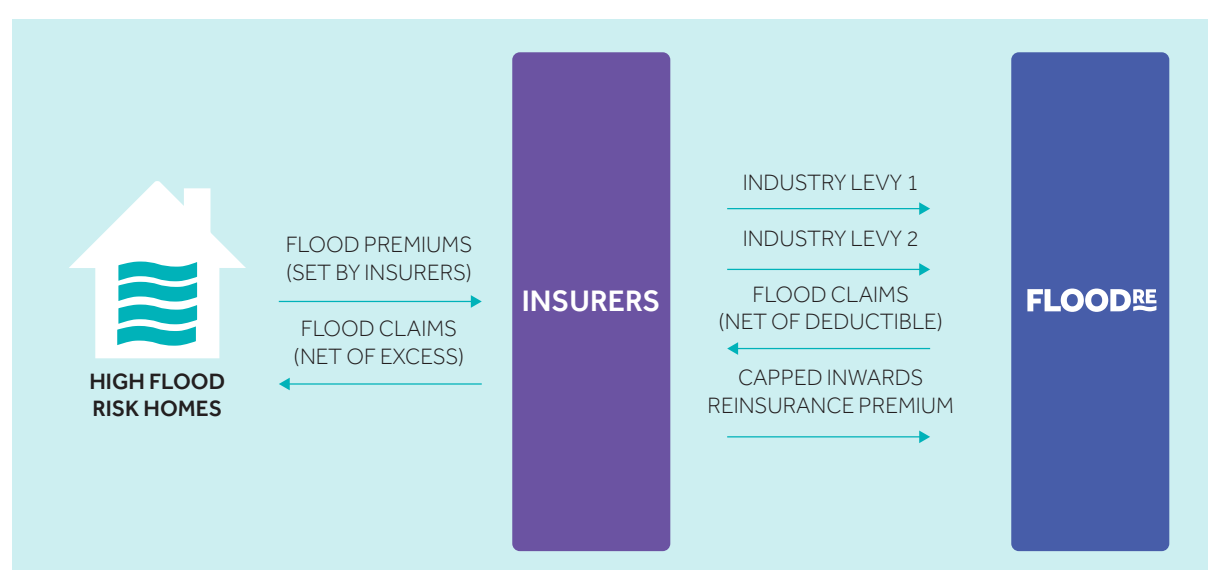
The cost of the subsidy provided through the Premium Thresholds will be met by a levy (known as Levy 1) raised from all insurers writing home insurance in the UK. For the first five years, Levy 1 will

total £180 million a year. The levy has a statutory basis and, as such, provides Flood Re with a certain income. This will allow Flood Re to purchase reinsurance and build up a surplus of funds during average years so that it can withstand large loss events from time to time (subject to the Liability Limit as agreed with the Government).

In the event that Levy 1 is not sufficient to meet requirements in any given year, Flood Re also has the ability to issue a compulsory call for additional funding from the industry through Levy II.

In the event of a claim, the customer will communicate, as now, with their insurer and Flood Re will reimburse insurers for the flood element of any claims that are paid to those customers. A standard deductible of £250 per policy for each claim will apply. The level of excess paid by the consumer will be set by the insurer. Figure 3 outlines the basic principles of the scheme.

Figure 3: Basic principles of Flood Re



Flood Re's resilience and public body status

Flood Re has been set up to tackle a public policy issue and will act as a public body. This means that, while it is an industry-run, industry-led and industry-owned company, as well as being regulated by the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA), it also has direct accountability to Parliament both for achieving the policy objectives set out in legislation, and for its custodianship of public money.^{xvii}

Given the important role that flood insurance can play, ensuring resilience of the Flood Re scheme is essential. Scenario testing has shown that Flood Re is a highly resilient model. It is designed to be robust to above a 1 in 200-year annual loss, providing up to £2.1 billion of cover through the global reinsurance market. Such a loss would be of a larger scale than anything seen in the last 100 years.

Next steps for Flood Re

Flood Re will become fully operational in April 2016. It will naturally take time for a full portfolio of ceded policies to develop and it is difficult to estimate with accuracy how many policies will be ceded to the scheme. Ultimately, it will be for insurers to choose which policies they cede. In making the decision to cede, each insurer will consider a range of commercial aspects, balancing the risk of a loss against the potential loss of profit.

1.3: Transitioning over 25 years

Given the potential economic and social problems associated with flooding and the desire to ensure the availability and affordability of flood insurance, there is a clear need to find a permanent and lasting solution. This solution will require action to be taken to ensure that the risks and costs of flooding are reduced for households at risk now and potentially at risk in the future.

As such, Flood Re has been designed to provide only temporary support for the insurance market for properties at high risk of flooding. At the end of 25 years from the date the Water Act 2014 received Royal Assent (May 2014), Flood Re will have been wound up and the subsidy provided through the scheme removed. A market with risk-reflective pricing should then be in place.

There are a number of reasons why it is desirable to transition to a market with risk-reflective pricing. As with the Statement of Principles, the scheme will continue to rely on a cross subsidy from those households with little risk of flooding to ensure affordability for those who are at higher risk. It also introduces operational costs that an open market would not incur. In the longer term continued subsidised pricing could reduce the incentive for the Government and others to invest in flood defences. While households are still subject to the emotional and disruptive costs of flooding, subsidised insurance and the security it provides, could also reduce incentives for householders to take steps to manage the risks and potential costs of flooding of their property. From an industry perspective, the presence of Flood Re could also reduce the incentive for insurers to invest in and develop more accurate models of flood risk.

Overall, these market distortions mean that, in the long-term, an insurance market with risk-reflective pricing for household flood risk would provide a more efficient solution and offer the potential for better outcomes for households at significant risk of flooding and those with low risks of flooding.

In broad terms this means that, between now and 2039, Flood Re will seek to reduce the subsidy provided to policies that are ceded to the scheme and the associated industry levy. This will allow households, industry, Government, the Devolved Administrations, Local Authorities and others the opportunity to both prepare for the changes and take any mitigating action that may be needed. To provide details of how it will approach this transition, Flood Re is required to produce a transition plan.

The statute requires that the plan outlines how Flood Re intends to manage transition, the likely course of Levy 1 and the Premium Thresholds over the period of operation of the scheme and make recommendations for any amendments or additional features that might be needed to manage transition successfully. The legislation requires that Flood Re publishes its first transition plan within three months of being designated and then at least every five years following that. This report is the first of those plans.

Chapter 2:

Understanding transition

2.1: What would successful transition look like?

The regulations providing the legislative basis for Flood Re outline the requirements of its approach to transitioning. The relevant section is outlined in box 1.

Box 1: Relevant section from The Flood Reinsurance (Scheme Funding and Administration) Regulations 2015^{xviii}

Transition to risk-reflective pricing of flood insurance

- 22.** (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 relating to the management of the transition referred to in paragraph (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 may be taken to manage the transition referred to in paragraph (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 payable under regulation 8 and the level of the reinsurance premium thresholds under regulations 15, 16 and 17 over the period of operation of the FR Scheme;
 - (c) such other information relating to the transition plan as the FR Scheme administrator considers it useful to publish.
- (4) The FR Scheme administrator must update and publish the transition plan 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.

In straightforward terms, the regulations state that the goal of transition is to reach a market where household flood insurance is available in a market with risk-reflective pricing. In practice, this requires:

- Risk-reflective pricing to be feasible: This requires that the technology to understand property level risk continues to develop over time so that insurers can accurately engage in risk-reflective pricing; and
- Flood Re intervention is removed: Over time, the level of subsidy provided to insurers in respect of household flood insurance cover and the levy raised from the industry as a whole should be removed.

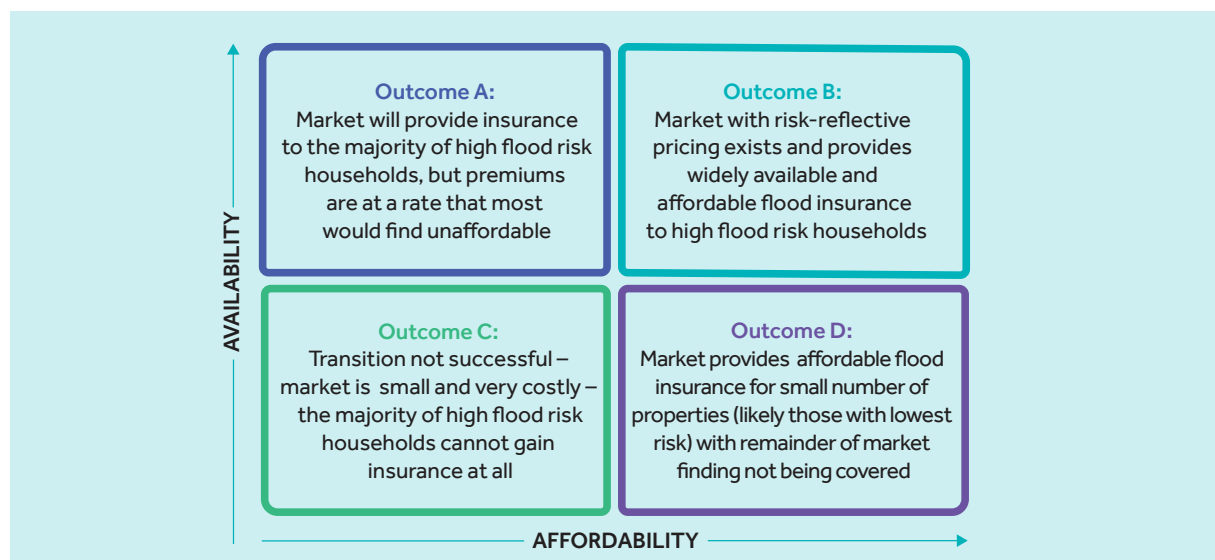
If both of these factors are achieved simultaneously, a market could exist with risk-reflective pricing. Flood Re therefore has a key role in ensuring that the subsidy associated with Flood Re is phased out over the scheme's lifetime. Doing so will ensure both that a cliff edge is not created whereby prices rise suddenly on the expiration of the scheme and that households, Government, the Devolved Administrations, Local Authorities and others have the chance to prepare for and take action to manage the risks of flooding and cost of claims.

Consideration of wider, non-statutory, goals

While achieving transition along these lines would meet the requirements set out in the regulations, it is also clear that doing so is compatible with a range of different outcomes for households in high flood risk areas. An obvious example is that the regulations do not say anything about the affordability or availability of household flood insurance once a risk-reflective market has been created. This means that Flood Re could achieve transition as set out in the regulations but the market could prove to be unaffordable for the majority of households.

Figure 4 outlines potential outcomes from a successful transition to a risk-reflective market in terms of affordability and availability. It shows three potential outcomes where, based on the legislation, transition might be regarded as successful. These range from a market where household flood insurance is widely available at a price that is regarded as affordable (outcome B) to one where insurance is technically available but the vast majority of households could not afford the premiums or excesses that are required (outcome A). Similarly, it is also possible that a small affordable market might exist for a group of relatively low-risk households, but the majority of higher-risk households are unable to purchase flood cover (outcome D).

Figure 4: Potential market outcomes from transition to risk-reflective pricing



The intended purpose of Flood Re is to promote the affordability and availability of flood insurance. As such, it is apparent that each of these three possible outcomes of transition should not be regarded equally.

With this in mind, in considering its approach to transition, Flood Re's Board of Directors believe that successful transition will rest on whether, once the subsidy associated with Flood Re has been removed, household insurance for properties at risk of flooding is both available and affordable. This suggests that the overall ambition should be to reach outcome B in figure 4.

Such an ambition is in all parties' best interests. As section 1.3 outlined, ensuring a successful transition would remove the need for a levy and cross subsidy from low flood risk households. It would remove the costs associated with running Flood Re and would lead to a more competitive and efficient market for household flood insurance.

This broader view of the role of transition is also implicit in the Government's approach to Flood Re. In setting up Flood Re, the Government signalled its preference for affordability by targeting outcome B and, in their response to the 2014 consultation, the Government outlined the twin responsibilities of Flood Re as being to protect "...those most vulnerable to a potential increase in the cost of flood insurance in the shorter term", while in the longer term "...helping prepare those households for the management of risk". The latter clearly focussing on the need to move to a market with reduced risk and, as a result, lower prices in the long-term.

2.2: The components of successful transition

For these reasons, this transition plan focuses both on the narrow goal of a phased removal of the subsidy provided through the Flood Re scheme, and on the steps that may need to be taken to ensure that a future market with risk-reflective pricing delivers affordable insurance for those households at risk of flooding.

In doing so, the plan is clear that Flood Re does not have direct control over the majority of the actions that will need to be taken. In particular, Flood Re does not control:

- Flood defence investment and maintenance;
- Building regulations and development choice for new builds;
- Insurer pricing and use of the Flood Re scheme;
- Central and Local Government policy on climate and adaptation;
- Market prices and use of Flood Re scheme;
- Post flood event responses;
- What hazard maps and research and development insurers invest in and how model vendors improve their mapping; or
- The behaviour and attitudes of consumers.

This means that achieving an affordable household flood insurance market with risk-reflective pricing will require collaboration between a range of individuals and agencies. For example, the Government, the Devolved Administrations, Local Authorities the insurance industry, loss adjusters, mortgage lenders, flood experts and interest groups and consumers themselves all have an important role to play alongside Flood Re's approach to transition. While this plan does not outline the action that these groups need to take, it does highlight how Flood Re will support them through the work it does.

2.3: Defining availability and affordability

Taking a wider view of the overall ambition of transition ultimately also requires a view to be taken over what is meant by the terms "available" and "affordable". The problem is that these are both subjective terms. For instance, affordability will mean very different things to different households, communities and interest groups. They are also concepts that vary both over time and between generations as household incomes change and preferences and attitudes towards risk evolve.

However, whatever the baseline, anything that reduces the costs of providing flood insurance (and therefore premiums) will improve affordability. For this reason, this plan outlines factors that impact on the costs of providing household flood insurance and the levers that are available to Flood Re and others to attempt to bring them down.

Chapter 3:

Options available to Flood Re

Chapter 2 outlined the twin goals of Flood Re's approach to transition as being to move to a market with risk-reflective pricing by managing the phased removal of the subsidy provided through the Flood Re scheme; and, within this context, supporting the development of a market with affordable household flood insurance that is widely available. This chapter considers the levers available to Flood Re to achieve these goals.

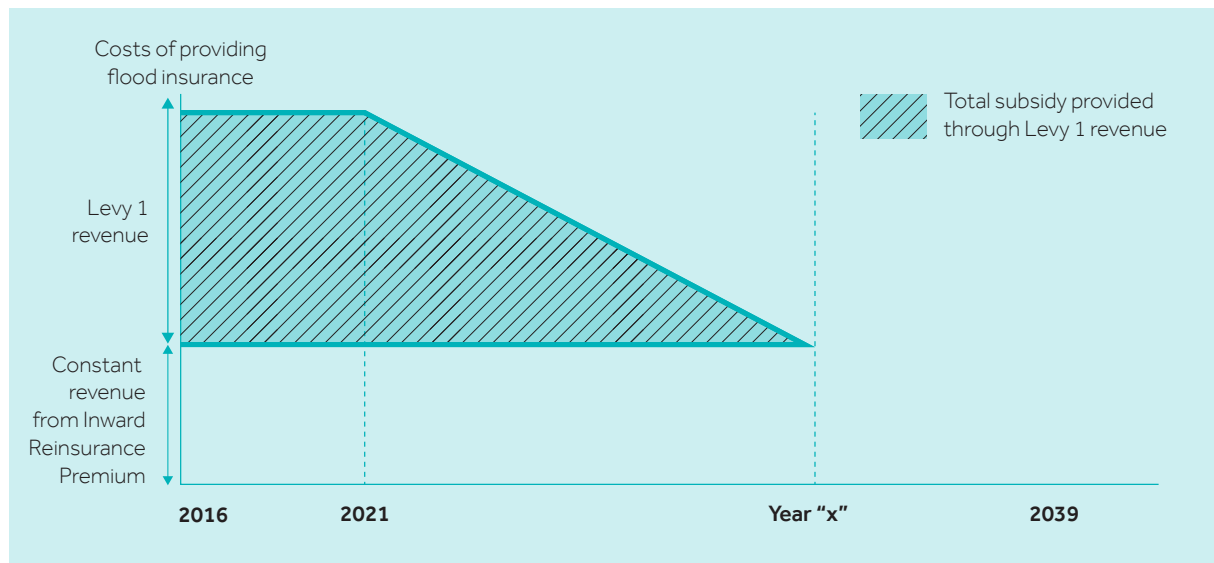
3.1: Phasing out the subsidy provided through Flood Re

Ultimately, transition requires that Levy 1 is completely removed. The implication is that the total costs of the Flood Re scheme will eventually be met by the Inwards Reinsurance Premiums. In turn, this means that the Premium Thresholds will need to be adjusted to meet the required level of revenue. How this occurs will clearly impact on affordability and the likelihood of achieving outcome B in figure 4.

In simple terms, the higher the revenue required, the higher the Premium Thresholds need to be and this will clearly lead to less affordable flood insurance premiums. This means that affordability of household flood insurance in a risk-reflective market will rest on the extent to which the costs of providing household flood insurance can be reduced over time:

- **With a reduction in the costs associated with providing flood insurance, Premium Thresholds could be held constant or fall over time:** In this scenario, Premium Thresholds are maintained in real terms and reductions in Levy 1 are driven by reductions in the costs of providing flood insurance. This could lead to both a risk-reflective and affordable market along the lines of outcome B; or
- **With no reduction in the costs associated with providing flood insurance, Premium Thresholds will need to increase over time:** In this scenario, Premium Thresholds would have to increase over time until the need for a subsidy is removed. While moving to a risk-reflective market, given the increases in Thresholds needed, it would be unlikely that this would be regarded as transition to an affordable market.

The implication is that, to transition to an affordable market consistent with outcome B, the costs of providing flood insurance need to be reduced over time. Figure 5 outlines a simplified example of this situation. It shows that, as the costs of providing household flood insurance fall over time, the proportion of income from Levy 1 also falls, until "Year x" when the subsidy is completely removed and 100% of the scheme's income comes from the Inward Reinsurance Premiums. Since reductions in Levy 1 have been driven by lower insurance costs, Premium Thresholds are allowed to remain constant in real terms over time.

Figure 5: Illustrative and simplified example of phasing out the subsidy provided through Flood Re

3.2: Moving towards an affordable market

Achieving an affordable market requires that the costs of providing flood insurance come down over time. As such, there is a clear need to understand what the drivers of these costs are and what Flood Re can do to influence them.

Drivers of the cost of providing flood insurance

In broad terms, in a private market the cost of providing flood insurance is driven by a wide range of factors, including:

- The risk of flooding: Higher risks are associated with higher costs;
- The costs of claims: Higher average claims are associated with higher costs; and
- Competition in the market: A greater level of competition is associated with lower costs.

Each of the main drivers is considered in more detail below and, while from this analysis it is clear that Flood Re has little direct control over many of the drivers of the costs of household flood insurance, it does have both a range of wider indirect levers and a supporting role to play in helping move to an affordable risk-reflective market.

3.3: The risk of flooding and costs of claims

Risk of flooding

Changes in the risk of flooding are an obvious driver of the cost of household flood insurance. Section 1.2 already demonstrated how a better understanding of the risks of household flooding has the potential to lead to higher premiums and excesses for those judged to be at risk.

Looking forward, many experts expect that the drivers and overall risks of flooding will continue to increase significantly over time. A range of estimates exist and there is a high level of uncertainty, but existing research has highlighted the potential impact of climate change. This includes a recent report contributing to the Government's Climate Change Risk Assessment, which highlights that, with existing trends in adaptation and no population growth, by the 2050s the number of residential properties exposed to frequent flooding (more than 1:75 years on average) could increase by around 20% and 50% under the 2% and 4% climate change scenarios respectively.^{xix}

With this in mind, it is not surprising that the Government views the management of flood risk as the prime policy lever in delivering affordable flood insurance:

“In the long-term, managing the risk of flooding will always be the best way of securing available and affordable flood insurance.”^{xx}

Here, the role of others in transitioning to an affordable market is obvious. For instance, the impact of policy making by Central and Local Government and the Devolved Administrations and, in particular, investment in flood defences, drainage and water management is clear to see. Looking back on the impact of past policy, the Environment Agency highlights that:

“The current risk of flooding would be far higher without the many decades of investment that have developed an extensive flood and coastal risk management infrastructure.”^{xxi}

Government estimates suggest that more than 165,000 households are better protected now than in 2011.^{xxii} As part of the agreement to set up Flood Re, the Government committed to investment in flood defences and has recently renewed this commitment to a six-year capital investment programme of £2.3 billion to 2021.^{xxiii} In this context, the Environment Agency’s report finds that, with a stable investment programme to 2021 overall flood risk could reduce by around 5%, compared to present day risk. If achieved, this would reduce the expected costs associated with providing flood insurance and, as such, would make the goal of moving to an affordable market more achievable.

Looking forward the Environment Agency also highlight that a higher level of investment could lead to further reductions in risk and, in response to the floods in recent months, the Government has announced a National Flood Resilience Review to report in the summer of 2016.

Overall, it is clear that, alongside Flood Re’s approach to transition, changes in flooding risk associated with climate change and the development and maintenance of flood defences will play a key role in securing an affordable market for household flood insurance.

However, they are not the only factors. A wide range of other factors, including planning and building regulations, impact on risks of flooding. Recent analysis suggests that up to 10,000 properties a year are being built on existing floodplains^{xxiv} and the Joseph Rowntree Foundation suggests that between 8% and 11% of all new dwellings in England were built in areas of high flood risk between 2000 and 2010.^{xxv} While such development does not necessarily always imply an increase in risk (for instance if the development is linked to investment in flood defences, potential risks might, at least in part, be mitigated), the presence of insurance can lead to a moral hazard problem and this is why Flood Re will only allow properties built prior to 2009 to be ceded to the scheme.

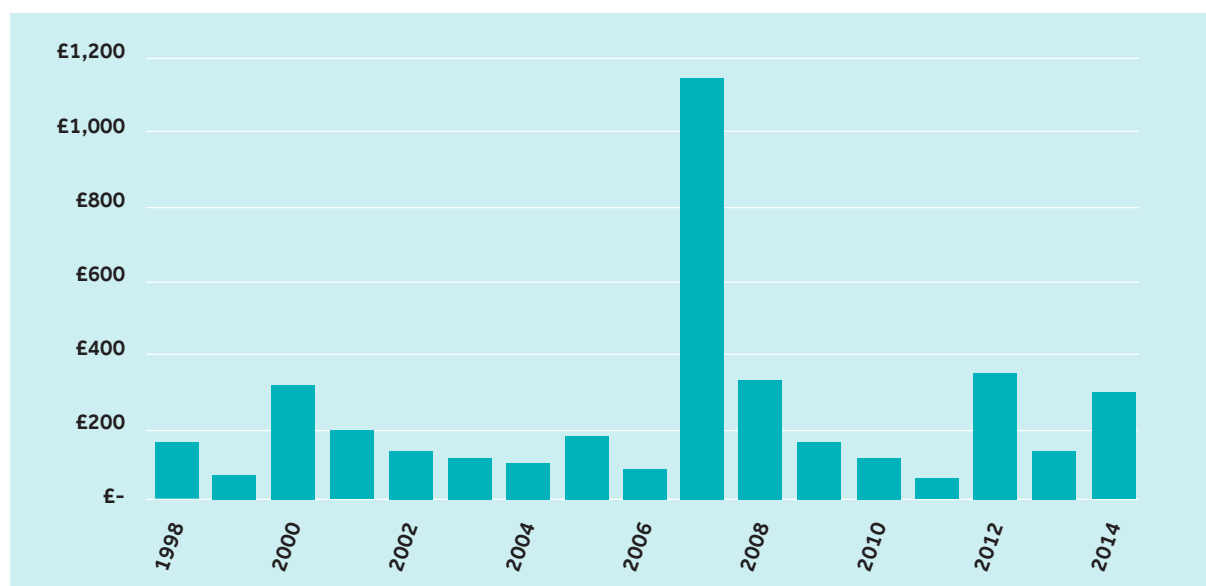
As this demonstrates, while Flood Re does not have direct control over planning and development decisions or building regulations, it can play a role in supporting the decisions that others make and, by doing so, increase the likelihood of moving to an affordable market.

Costs of flood claims

It is also apparent that the cost of insurance will be driven by the expected costs of claims. Looking back, given the variation in the number of properties affected, it is unsurprising that the annual cost of insurance claims varies widely. Severe events in 2007 and 2012 resulted in annual domestic flood

insurance claims of over £1 billion and £350 million respectively. Excluding these years, the average annual cost since 2000 has been around £160 million.^{xxvi}

Figure 6: Costs of household insurance claims associated with flooding (£, million)



Source: ABI, in 2014 prices

Given the influence that the cost of claims has over insurance premiums, a key area for ensuring an affordable market will be to try to manage the cost of claims down. In practice, for any given level of flood risk, the lower the cost of average claims associated with a given flood event, the lower the cost of insurance. The cost of claims is determined by a number of key areas, including:

- **Repairing flood damage:** Perhaps the most obvious cost is the need to repair damage caused by flooding. This could typically include replacing floorboards, re-plastering and redecorating affected rooms, replacing damaged furnishings and repairing or replacing damaged electrics and electrical goods. More major building works may also be needed;
- **Drying out flooded properties:** Before properties can be repaired, floodwater needs to be removed and the property dried out, cleaned and disinfected. This can take a considerable time even for relatively shallow flooding;
- **Temporarily rehousing householders:** Since drying out, cleaning and repairing flooded properties can take a long time, householders often need to be rehoused while this happens. Evidence from previous flood events suggests that the majority of affected householders will be back in their property within a year. However, the most significant repairs can lead to householders needing temporary accommodation for over a year; and
- **Administration costs:** The whole process produces administration costs as a range of professions from surveyors, loss adjusters, specialist cleaning and drying companies, and builders and decorators will all need to be coordinated.

Overall, this means that the level of costs will hinge on the extent of the damage and the length of time it takes to dry-out and repair the property. This means that anything that can reduce either the damage or time involved will also reduce the costs. Flood Re has little direct influence over these factors, but the next section highlights what households and insurers could do to reduce these costs and how Flood Re could support that action.

3.4: Action from households to reduce risk and claim costs

The sections above highlighted some of the key drivers of the likelihood and costs of flooding and several of the range of policy levers available to Central and Local Government to help mitigate them. Households can also take action themselves to reduce the risks of their property being flooded and the costs associated with flooding where it does occur.

In this respect, the ABI, National Flood Forum, Scottish Flood Forum and campaigns such as Know Your Flood Risk, all have advice for how households can prepare for and minimise the potential costs of flooding. For instance by developing a "Flood Plan" and preparing when there is a risk by moving possessions to higher floors in the house.^{xxvii}

There are also wider options available to households to help them protect themselves and as part of its approach to transition, Flood Re has a role to play in providing information that could help households take this action. The relevant part of the regulations is shown in box 2 and outlines that Flood Re will provide insurers with information that they may pass on to policyholders explaining how to find information about flood risk and management, details of the scheme itself and an outline of the potential impacts of transition.

Box 2: Relevant section of The Flood Reinsurance (Scheme Funding and Administration) Regulations 2015^{xxviii}

Provision of information to relevant insurers

- 26.** By 1st April of each year, the FR Scheme administrator must provide the following information to relevant insurers who have effected a buildings policy, contents policy or combined policy reinsured under the FR Scheme in the immediately preceding financial year, for the purposes of enabling those insurers to supply that information to holders of those policies—
- (a) information about how to find out about the levels of flood risk to which an area in which household premises are situated is subject and general information about how to find out about how any flood risk may be managed;
 - (b) general information about the FR Scheme; and
 - (c) general information about the estimated impact of the transition referred to in regulation 22(1) on the cost of those insurance policies.

The need for households to take action themselves and the role of Government in facilitating this is not a new theme. The Pitt Review of the 2007 floods highlighted the need to consider how to encourage more flood prone communities and properties to take up property level protection (PLP) measures.^{xxix} The Government has also recently committed to providing grants of up to £5,000 to help people afford the costs of installing PLP measures.^{xxx}

There are two broad types of PLP measures: those that act to reduce the risk of an individual property flooding (resistance measures) and those that reduce the potential costs of repair once flooding has occurred (resilience measures).

Potential benefits of PLP

Since 2007 the PLP market and range of available measures has developed considerably, in part due to grant schemes and pilots run by Defra and the Environment Agency. However, given its recent and rapid development, it is no surprise that relatively little is currently known about the overall impact of PLP on the risks and costs of flooding. The Environment Agency, recently highlighted that:

“In assessing the financial benefits of any proposed flood defence scheme, methods for estimating the cost–benefits of larger structural schemes are well established. The methods for assessing localised protection – such as flood doors, operating flood gates and providing flood warnings to allow the public to move contents or evacuate flood risk areas – is less well defined. This is especially the case when a portfolio of flood risk management (FRM) measures may be required to obtain a certain standard of protection.”^{xxx}

While relatively little is currently known, evidence is beginning to accumulate. An Environment Agency report highlights the potential impact of more properties taking up PLP measures, finding that increased uptake of resistance measures significantly increases the number of properties judged to be at very low risk (moving properties from the three risk categories above this).^{xxxii}

Anecdotal evidence of the effectiveness of both resistance and resilience measures is also beginning to build up, with advocates highlighting the improved experience of households in the areas affected by recent flood events who had the measures installed.

However, evidence on the effectiveness of the different types of PLP measures is, overall, mixed. For instance, research has suggested that temporary resistance measures can reduce the costs of damage by about 50% when properly deployed. For households with a relatively high risk, resistance measures are found to be economically worthwhile.^{xxxiii} However, the benefits of resilience measures are less well defined, with existing research providing mixed evidence on the cost-effectiveness of investment from a public spending perspective.^{xxxiv}

Low take-up of PLP

This relative lack of evidence is likely to be one of the reasons why PLP measures are not widely taken up by at-risk households. Recent research looked at the implementation of resilience measures by at-risk English households and showed that steps to increase resilience had only been taken by around a third of previously flooded households and just 6% of those who were aware of their flood risk but had not been flooded.^{xxxv} This has even been true where the Government has offered to partially or wholly fund the interventions.

There are a number of likely reasons for this. Moral hazard has been shown to be a problem, where the presence of insurance reduces the incentive for households to invest in resilience measures.^{xxxvi} Households can also struggle to understand the likelihood of flooding and, when faced with uncertainty in decision-making, behavioural economics suggests that individuals may choose to delay decisions or not take action at all.^{xxxvii} The costs of taking action can also be prohibitive for some households and the fact that insurers often will not take adaptations

into account when providing quotes for insurance means that households cannot see the immediate financial benefit.^{xxxviii} More broadly, there is also a gap between public and policy makers' perceptions over who should take responsibility.^{xxxix} Recent research has also shown that problems with product quality, installation, maintenance and use in flood situations have put some householders off as they have meant some measures were ineffective when needed.^{xl}

Encouraging an increase in take-up

Recent flooding events will provide further evidence on the effective use of PLP and further research is already being undertaken by industry and by the Government. For instance, the Joseph Rowntree Foundation and the University of the West of England are both undertaking work in this area. The Government has also announced a National Flood Resilience Review in response to this winter's floods.^{xli}

Looking forward it seems likely that, as results from this research become available and more is understood about the various options available and their respective effectiveness, some forms of PLP could have an important role in helping households to reduce the risks and costs associated with flooding. However, the only existing lever to encourage take-up that Flood Re has, is the information that it must provide insurers to pass on to policyholders and its overall approach to transition (in so far as rising prices will, on their own, incentivise householders to take action).

3.5: The role of industry in reducing risks and claim costs

With the potential savings from PLP and relatively low take-up in mind, it is clear that insurers might also have a role to play. For example, as firmer evidence of the potential impacts of PLP measures is available, it may be possible for more insurers to reflect these measures in the premiums of high risk properties. That would mean that, just like certain types of locks on doors can reduce household insurance premiums, the installation of resistance and resilience measures could also lead to lower premiums. As a result, householders would face a clearer financial incentive for investing in these measures.

Another obvious area is the approach insurers have to repair. The choice of approach will impact on the costs to dry-out, clean and repair a property and the length of time that householders need to be in temporary accommodation. Anything that can reduce these costs would lead to a reduction in the costs of providing flood insurance.

The approach to repair also plays a part in determining how resilient the property is to future flooding. For instance, emerging research demonstrates that, while the installation of resilience measures (e.g. the use of flood resilient plaster and resilient flooring) can be costly, where it is undertaken as part of repair or refurbishment it can prove cost-effective for high risk properties.^{xlii}

This means that it is essential to ensure that the most effective and efficient methods are used when properties are being dried-out and repaired and that both the short and long-term costs are considered.

As with household action, Flood Re's direct levers over insurers' actions on repair and consideration of PLP measures are limited. However, by bringing together evidence of the factors impacting on the costs of repair and methods which might reduce costs, Flood Re can support insurers to bring down costs.

3.6: Flood Re's supporting role in reducing risks and claim costs

Overall, the potential role of both households and insurers raises the question of how Flood Re can use the tools it already has to prompt action and what other steps it might take in future.

Along these lines, Flood Re has already committed to taking steps to consider, within its first two years of operation, what role may be appropriate for it to play with regard to incentivising households and insurers to implement property level measures. Any potential actions will need to be guided by a strong evidence base and implemented with regulatory approval and support from Government, industry and stakeholders including consumer representatives.

3.7: Competition in the market

In most private markets, price and, therefore, affordability is driven by the presence of competition. With engaged consumers making informed decisions over the products and services they buy, firms are incentivised to improve products and drive prices down through efficiency and innovation. In short, in a competitive market, prices will be lower than would otherwise be the case.

This has been seen in recent years in the UK home insurance market, where competition has driven reductions in average premiums. Well over 650 insurers are currently authorised to underwrite household policies in the market and 20.2 million policies were written in 2014. However, in contrast to the overall market, households in flood risk areas have had a relatively limited choice of cover for flood risks.

This was one of the major drivers for the creation of Flood Re and its introduction should serve to increase competition. Given that Premium Thresholds are currently set at below risk-reflective levels for high risk properties, more insurers should be able to enter the market and households living in high risk areas should have access to more options when searching for a home insurance quote.

However, other parties will also need to adapt to ensure that competition works effectively. For instance, insurers will need to ensure that their distribution partners are ready for and adapt to the presence of Flood Re. With around a third of all household insurance policies distributed through Price Comparison Websites (PCWs) and many of those purchasing directly from insurers first assessing potential quotes using a PCW, the role of these aggregators could be particularly important for competition.

More generally, the extent of competition will also rely on consumers engaging with the market, making active choices between different providers and doing so repeatedly over time. This is an area that, across general insurance markets, has proven to be challenging. The Financial Conduct Authority recently outlined concerns that consumer inertia in this area was resulting in higher-than-necessary premiums.^{xliii} The Government has also indicated its desire to take action to address these perceived problems.^{xliv}

Overall, the introduction of Flood Re is likely to increase competition for insurance for those households at risk of flooding, but affordability will require consumers to be more actively engaged in the market than is often the case. This means that, while consumer behaviour and levels of engagement are something that Flood Re does not have a direct influence over, they will be important for ensuring that a risk-reflective market for flood insurance is also affordable. With this in mind, Flood Re will consider what action it can take to support this behaviour.

3.8: Action needed to transition to an affordable risk-reflective market

The affordability of household flood insurance will ultimately depend on the risks of flooding, the costs associated with claims from flood events and the extent of competition in the market. As this section has outlined, Flood Re has little direct policy influence over these issues. This means that while it can plan and take direct action to transition smoothly to a market with risk-reflective pricing, if this market is going to be affordable, a wide range of parties will need to take action. Figure 7 outlines that Flood Re has a potentially important role in supporting this action to secure an affordable market.

Figure 7: Examples of the role that Flood Re could play in helping to reduce the costs of providing flood insurance

Insurance cost driver	Flood Re's potential role		
	Direct lever	Indirect lever	Role in supporting action of others
Risk of flooding			
Likelihood of flood events	No	No	Yes. For example, through use of its data to guide investment in flood defences
Likelihood of a given household flooding	No	Yes. For example, through the information it provides on steps householders might take to protect their property	Yes. For example, through building understanding of the impacts of property level resistance measures
Costs of flood claims			
Severity of flood event	No	No	Yes. For example, through use of its data to guide investment in flood defences
Cost of repair (including re-housing)	No	Yes. For example, through the information it provides on steps householders might take to protect their property	Yes. For example, through increasing understanding of the impacts of property level resistance and resilience measures. Also through the data it holds on claims costs
Administration	No	No	No
Competition in the market			
Number of firms	No	Yes. The creation of Flood Re should encourage new entrants into the market	—
Consumer engagement	No	Yes. The creation of Flood Re should increase engagement by giving households more choice over their household flood insurance provider	—

Chapter 4:

Flood Re's first transition plan

4.1: Overview of the approach

This report has outlined the broad context under which Flood Re will be considering how to transition to a risk-reflective market for household flood insurance between 2016 and 2039. It has highlighted the inherent uncertainty under which Flood Re is operating and the challenges that factors like climate change might create. It has also outlined the fact that, on its own, Flood Re is unlikely to be able to transition to a market that has risk-reflective pricing of household flood insurance that is both available and affordable to those that need it. Achieving this will require action from many other parties including Central and Local Government, industry and households themselves.

The inherent uncertainty and volatility of flooding means that Flood Re will need to adapt its approach to transition to factor in the changing environment in which it is operating. It will also need to consider wider factors like revisions to the estimates of the impact of climate change and how other parties respond to these changes. At this point in time, it is also still unclear what decisions firms will make as to the number and profile of policies that are ceded to Flood Re.

These factors make it impossible for this first plan to provide a comprehensive outline of the way in which Flood Re will remove the subsidy provided through the scheme over the next 23 years. However, despite the uncertainty, it is also clear that to reach the goal, steps will need to start to be taken quickly. To support this, Flood Re can provide an indication of how it plans to approach transition and how it might respond to other changes in the market, within its existing powers.

This first plan does that. It:

- Provides details of how future plans will approach analysing and setting out the steps that will need to be taken;
- Sets out details of the approach that will be taken to changing the parameters of the scheme in the immediate future; and
- Outlines other steps that Flood Re will take to support householders and others prepare for the removal of the scheme subsidy and take the action needed to manage the risks and reduce costs of flooding.

4.2: Approach for future plans

Transition requires that, between 2016 and 2039, the gap between the inwards Reinsurance Premiums and the true underlying technical risk cost (risk-reflective price) reduces to zero.

In order to achieve that, at each review point, changes to the terms on which risks can be ceded to the scheme can be recommended by the Flood Re Directors if it is considered necessary. Following discussion with the Secretary of State, Secondary Legislation would then need to be

updated. Future transition plans will give an overview of the expected course of these terms over the remainder of the scheme. While these will not provide a full schedule of future changes, they will give an indication of the approach that Flood Re proposes to take.

The announced changes and future expectations will be based on up-to-date actuarial modelling (including allowances for climate change) of the policies and exposures in Flood Re, assessing actual and expected losses and reinsurance costs. An indicative outline of how this might be approached for future plans is outlined at Annex 1.

4.3: The first plan - scheme parameters

Premium Thresholds

As outlined in the statute, at the start of each financial year (from 1st April 2017) the Premium Thresholds will each rise in line with the Consumer Prices Index (CPI).

The timing of this transition plan makes it impossible to provide a detailed picture of the future course of the Thresholds over the longer term. This will only be possible when Flood Re is fully functioning and has full knowledge of the level and distribution of risks ceded to the scheme, how firms respond to flood events (in terms of their ceding behaviour) and how risks and costs are changing. Future plans will have the benefit of this information and will contain more detail on the expected course of the Thresholds.

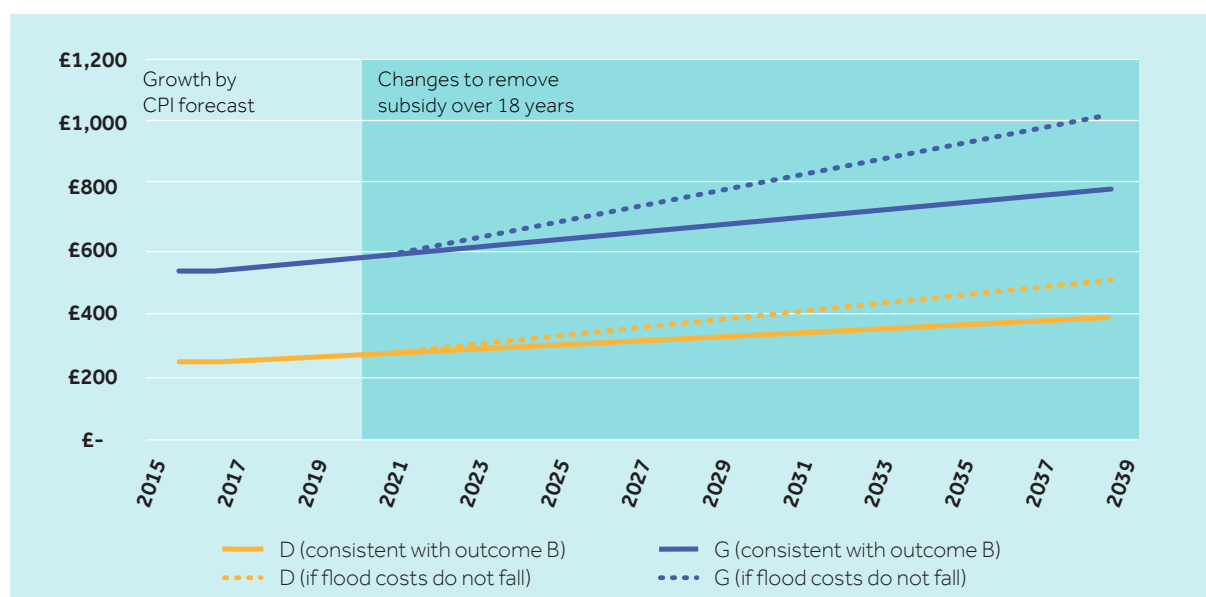
They may also consider how and whether Thresholds should change in such a way as to either attempt to increase penetration or phase out the subsidy provided through the scheme more quickly for those households better able to afford the move to a risk-reflective price. For example, they could consider whether subsidies might be removed more quickly for households in higher council tax bands. Doing so would reduce the scale and scope of the scheme, whilst continuing to provide protection and a longer period to prepare for those households judged least able to afford the risk-reflective market.

Indicative longer term changes to Premium Thresholds

Section 3.1 outlined that, unless the costs of providing household flood insurance fall (for instance through a reduction in risk or the cost of repair) transitioning to a risk-reflective market would require Premium Thresholds to rise over time.

To demonstrate the importance of action to reduce the costs of providing flood insurance, figure 8 shows that, if the costs of providing flood insurance fall over time, Premium Thresholds for band D and G properties could be held constant in real terms (by increasing in line with inflation – represented by solid lines), as the reduction in Levy 1 is offset by reduced insurance costs.

If action to manage the risks and costs of flooding does not take place, to remove the subsidy from the scheme, Premium Thresholds would need to rise by more than inflation (represented by dotted lines) and the result would not be consistent with outcome B.

Figure 8: Indicative potential changes to Premium Thresholds

Levy 1

The section above has shown that, all else being equal, the need for Levy 1 funding will be reduced as the costs of providing flood insurance fall or the level of Premium Thresholds rise. As part of its standard practices, Flood Re will calculate the required level of Levy 1 annually in advance of 1 April. Future transition plans will outline the impact on the expected level of Levy 1 of any announced and projected changes in the Premium Thresholds. They will also include any assessments of the impact of changes to solvency requirements.

Based on the Premium Thresholds rising by the forecast level of CPI over the next five years, the expectation is that Levy 1 will be fixed at £180 million over that period.

Underwriting scope and excess levels

Reflecting the current lack of data on policies ceded to the scheme, there are no plans to seek to alter the underwriting scope or excess levels of the scheme. The 2009 cut-off for eligibility for properties to be ceded to the scheme will be in place when Flood Re comes into operation.

In future, transition plans will have the ability to recommend and, with agreement of the Government and industry and subsequent legislation, implement changes to the underwriting scope and levels of excess. A wide range of approaches could be considered. However, any proposed changes will need to be built on a firm evidence base that shows how they will contribute to the transition to an affordable risk-reflective market consistent with outcome B.

4.4: The first plan – wider steps to support transition

As already highlighted, moving to an affordable risk-reflective market will require that the revenue impact of reducing the subsidy provided through Levy 1 is offset by reductions in the cost of providing insurance. The following sections outline steps that Flood Re will take to work in partnership with other parties to support this.

Understanding affordability and availability

Decisions over the actions needed to tackle the risks and costs of flooding will need to be driven by up-to-date information and evidence. Flood Re has a clear role in supporting these decisions by undertaking work to understand how the market is developing both as Flood Re is introduced and as, over time, its parameters are changed.

To do this:

- Flood Re has commissioned a study that will create a benchmark of prices and availability of household flood insurance. This will complement the work already undertaken by Defra in this area. It will assess the actual costs and availability of insurance for a set of at-risk households;
- This exercise will be repeated regularly over the life of Flood Re and will consider how prices and availability vary by different household characteristics (e.g. council tax band).

The results of these studies will create a benchmark of prices and availability before Flood Re is introduced and allow an assessment of some of the impacts that Flood Re has had on the market. They will also allow a comparison over time of how, with Flood Re in place, the market performs in terms of price and availability of insurance. To fully understand whether an affordable market could exist without Flood Re intervention, evidence is also needed as to what prices and availability would be like if the Flood Re scheme were no longer in place.

This is a difficult question to answer accurately, so to complement the benchmarking exercise, Flood Re will undertake research to understand whether, in the absence of the Flood Re scheme, an affordable market could exist.

Incentivising action through Flood Re's data asset

The approach outlined above will go some way towards improving the knowledge and understanding of the risks and costs of household flooding. However, it is also clear that Flood Re could go much further in providing support to a range of parties to take the action needed to create an affordable risk-reflective market.

An obvious example is the unique data asset that Flood Re will hold. Once up and running, based on the policies ceded to it, Flood Re will hold the most complete map of high flood risk homes. As floods occur, it will also have a complete picture of which of these properties are flooded, the associated cost of claims and how the costs of claims are made up (e.g. splits between repair and accommodation costs).

This will be an invaluable data asset. Along with guiding both Flood Re's business-as-usual actions and its approach to transition, these data could provide vital insight to a range of different parties.

For Government, Local Authorities and the Devolved Administrations, it could be used to assess and better understand changing flood risks. In turn this understanding could be used to analyse the coverage and effectiveness of flood defences and to highlight where gaps might exist and where future investment would be most effectively focused.

Similarly, it could provide vital data both for the Environment Agency in validating flood models and for the Committee on Climate Change to undertake their statutory duty to report on changing risks and preparedness for climate change. Academics and researchers could also use these data to understand flood risks and costs and, combined with other data sources, they could be used

to gain a better understanding of the effectiveness of approaches like the installation of property level resistance and resilience measures. The data could also be used to better understand the links between changing flood risks and property prices.

Householders themselves could also gain from the data. For instance, analysis could be used to better inform households about the risk they face and the potential costs of flooding they could be exposed to. In turn, this could help households make decisions about the action they could take to mitigate these risks and costs.

These are only a few of the advantages that might be gained from opening up these data. However, there are also disadvantages and barriers to doing so. One clear potential disadvantage is that it could reduce the incentive for insurers to invest in and develop more sophisticated methods of flood risk evaluation and mapping. As highlighted earlier, the development of these tools will be vital for the creation of a risk-reflective market. Along these same lines, there are also barriers to opening up the data in terms of competition law and questions over intellectual property and the use of personal data.

This means that, while there is an apparent public interest case for opening these data up, before doing so, there needs to be careful consideration of the potential unintended consequences and associated risks. To ensure the most is made of this data asset:

- Flood Re will undertake work to understand whether and how the data it collects on flood risks and costs might be shared to support transition to an affordable risk-reflective market; and
- This work will take into consideration factors such as the privacy of personal data, competition law and the ownership of intellectual property. It will outline a set of guiding principles for how Flood Re can share this data with others, including Government, the Devolved Administrations and non-departmental bodies, academia and wider stakeholders including industry. A full range of stakeholders will be brought into this work.

Incentivising action from households and insurers

The regulations outline the role that Flood Re needs to play in communicating with insurance companies so that they are able to provide information to households about the risks of flooding they face, the details of the Flood Re scheme and mitigating action that they might be able to take to manage the risk and cost of flooding. As well as this role in communication, Flood Re has committed to assessing how it might play a more direct role in incentivising households and insurers to take action.

A wide range of options will be considered but, whatever form these potential incentives take, they will need to be developed on a strong evidence base that demonstrates the positive role they can play in transitioning to a risk-reflective market. They will also need to drive stronger take-up than previous schemes and will require effective communication with households to ensure that they understand and respond to the incentives in place.

There is also likely to be a role for the insurance industry to play. Action from households is likely, in part, to rest on insurers' approach to resilient repair and betterment and whether insurers will take property level measures into account when quoting premiums for cover. As outlined earlier, in collaboration with Flood Re, insurers will also have a key role to play in building understanding around the approaches to repair and drying-out that are most cost effective.

Overall this suggests that future work to understand how to promote household action should consider the role of communication, more direct incentives and supporting action from Government and industry as a package. To do this:

- Flood Re will seek out and engage a wide range of stakeholders and look to build strong partnerships to take this work forward. This will include, amongst others, Central and Local Government, the Devolved Administrations, non-departmental bodies, flood experts, household representatives, experts in behavioural science and representatives from industries including insurance and flood protection;
- The work will consider:
 1. How insurers might be supported to bring the costs of repair down;
 2. The evidence surrounding the impacts of property and community level interventions, gaps that exist in the level or quality of knowledge and how they might be filled, including the role that Flood Re can play;
 3. Evidence on the existing barriers to take-up and how householders can be incentivised to take action where there is evidence that it would prove worthwhile; and
 4. The role that Flood Re might play in prompting this action from households, insurers and others to boost the take-up of property level resistance and reliance measures.
- Where gaps in evidence are found, Flood Re will consider how it might use its convening role to support new research that would improve understanding and the likelihood of the successful transition to an affordable household flood insurance market; and
- Flood Re will look to provide updates as information becomes available and will report back with initial findings in its next transition plan.

As part of this work, Flood Re will also both consider how best to track household understanding of these issues and work with the industry to explore the feasibility of beginning to collect data on resilience measures taken by households with policies ceded to the scheme.

Competition in the market

As well as helping households and industry to reduce the costs of flood claims, communication with households can also play a much wider role in ensuring that households understand the market and drive competition through active engagement. This is an issue of current interest to the FCA in its consideration of the renewals process for the general insurance market. Flood Re is likely to have a relatively limited role to play here. However, going forward, it will explore how to ensure that those households with policies ceded to Flood Re receive the information they need to make informed and accurate choices about the cover they receive.

More generally, with the important role that competition plays in ensuring affordability in the market, as Flood Re develops it will track measures of competition in the market. It will also use its data to better understand whether competition is driving down the costs of repair to an appropriate level. Subject to these assessments, future transition plans may focus more attention on this area.

4.5: Next steps

This first transition plan has outlined the uncertainty and challenges surrounding Flood Re's approach to transitioning to an affordable market for household flood insurance with risk-reflective pricing. These challenges are particularly great for this first iteration as much of the data needed to outline a firm plan will only be available when full knowledge of the risks ceded to Flood Re can be assessed.

However, while uncertain, this plan has outlined the expected course of the main terms on which policies may be ceded to Flood Re and the expected level of industry funding (the Premium Threshold and Levy 1). It has also outlined a commitment to significant areas of work that Flood Re will be undertaking in the coming months and years.

This will be vital in ensuring that any future action is guided by a robust evidence base. It will also ensure both that the next transition plan can provide greater detail on how Flood Re will approach transition up to 2039 and that it can fully play its part in supporting the action that others will need to take to reach an affordable market for household flood insurance. Flood Re is committed to bringing together the full range of stakeholders and seeking out and developing partnerships with other organisations and groups to deliver this important work and it is hoped that others will support, promote and contribute to this approach.

To support the commitment to engage with a wide range of stakeholders, Flood Re will constitute an advisory body to support its work in this area. Further details including the terms of reference will be detailed in due course. The next plan will report back on this work and be published in time to inform the first of Flood Re's five-year reviews.

Annex 1: Indicative process to support the transition to risk-reflective pricing

- Flood Re will monitor exposure to potential floods as well as actual claims experience. At the end of the first five-year period of operation, Flood Re will have established a better understanding of the potential for future flood claims from an established Flood Re portfolio;
- Financial models will be used to produce projections for a wide range of potential outcomes under a range of input assumptions reflecting future scenarios of Flood Re underwriting exposure, premium income and outwards reinsurance structures;
- These financial projections will reflect the latest understanding of the risk of flooding across the UK, including developments in understanding the impact of climate change and flood risk management activity, to estimate underlying technical risk costs;
- Different levels of Inwards Premiums and Levy income, together with the estimated likely number of ceded properties based on an assessment of price elasticity, can then be modelled;
- A key consideration will be the extent and timing of closing the gap between Flood Re's Inwards Premium Tariff and the assessed underlying technical risk cost, and how this might vary by council tax band;
- Full projections of Flood Re's future financial position can then be established to assess the projected capital position and future regulatory capital requirement for each of the scenarios considered;
- Options for pricing transition will be discussed by the Flood Re Board to establish which best serves the objectives of Flood Re; and
- Flood Re and Ministers will discuss the options, and (subject to any changes) agree on the option to be taken forward for the next five-year period.

The agreed levy and Premium Threshold tariff will be set out in revised secondary legislation, together with changes to FR Scheme rules on underwriting scope.

Endnotes

- i ABI data.
- ii The Environment Agency uses four flood likelihood categories: High as a 1 in 30 (3.3%) chance or more in any one year; Medium as less than 1 in 30 (3.3%) but greater than or equal to 1 in 100 (1%) chance in any one year; Low as less than 1 in 100 (1%) but greater than or equal to 1 in 1,000 (0.1%) change in any one year; and Very Low as properties with less than 1 in 1,000 (0.1%) change in any one year.
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- xviii Flood Reinsurance (Scheme Funding and Administration) Regulations 2015 www.legislation.gov.uk/uksi/2015/1902/pdfs/ukxi_20151902_en.pdf Accessed 9th January 2016.
- xix Sayers, P.B, Horritt, M.S., Penning-Rowsell, E and McKenzie, A., (2015). Climate change risk assessment 2017: projections of future flood risk in the UK. Research undertaken by Sayers and Partners on behalf of the Committee on Climate Change. Published by Committee on Climate Change, London.
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- xxvi Source: Flood Re estimates using ABI data in 2014 prices.
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