Flood Re Limited

Solvency and Financial Condition Report

for the year ended 31 March 2022

# Contents

# Summary

Flood Re Limited ("Flood Re" or "the Company") is the Scheme Administrator for the Flood Reinsurance Scheme ("Flood Re Scheme") and is principally engaged in the provision of flood peril reinsurance cover within the UK. The Flood Re Scheme is a joint initiative between the UK insurance industry and the UK Government. The Flood Re Scheme was established by the Water Act 2014. Further details of the Scheme can be found on the Company's website at www.floodre.co.uk.

Flood Re's purpose is to promote the availability and affordability of flood insurance for eligible homes, while minimising the costs of doing so, and manage, over its lifetime, the transition to risk reflective pricing for household flood insurance.

In order to do this, Flood Re provides reinsurance cover at a subsidised fixed rate to cedants, resulting in an expected underwriting loss each financial year. The Company finances this through a £180m Levy on UK household insurers. The Levy also finances the purchase of an outwards reinsurance programme to protect the Company up to a £2.286bn (2021: £2.273bn) maximum Liability Limit (the Liability Limit).

Flood Re is a mutual reinsurer and was incorporated in August 2013 as a private UK Company limited by guarantee. Regulations designating the Flood Re Scheme came into force on 11 November 2015, providing Flood Re with the power necessary to fulfil its purpose.

On 1 April 2016, Flood Re was authorised by the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA").

Flood Re launched on 4 April 2016.

## Financial assessment and going concern

Outside of the potential claims inflationary pressures from COVID-19, Flood Re has limited direct financial exposure to the impacts of COVID-19. This is due to the Company's single peril risk exposure, conservative investment portfolio, secure level of capitalisation and the Scheme's financial structure.

The majority of the first order implications of COVID-19 have diminished over the course of 2021/22, particularly by year end, with other risks drivers (e.g., current heightened inflationary environment) taking precedence for risk management oversight and action. In terms of Flood Re's operating model, in the latter half of 2021/22 we have moved from a fully remote working environment in response to COVID-19 lockdowns to a Hybrid Working Model which seeks to draw on the benefits of both flexible home working and in office cross-team collaboration.

As such, the Board considers it appropriate to prepare these Financial Statements on a going concern basis.

## Business and performance

The results of the Company for the year ended 31 March 2022 show a profit before tax of £131.9m (2021: £141.8m), with an income from the Levy of £180m (2021: £180m) and gross written premiums of £46.4m (2021: £38.8m). Eligible and available own funds under the Solvency II and Insurance (Amendment, etc.) (EU Exit) Regulations 2019 (Solvency II regulations) stand at £613.6m (2021: £490.7m). During the financial year, we incurred gross claims of £32.1 m (2021: £8.2m).

## System of Governance

The System of Governance is considered appropriate to the Company given the nature, scale and complexity of the operations. The governance structure of the Company has operated throughout the year with the Committees highlighted in Section B.1.

The Company ensures that individuals meet the Fit and Proper requirements at all times.

Flood Re uses the UK financial industry standard "three lines of defence" approach to managing risks.

Flood Re's business strategy relies on a number of operational outsourcing arrangements, some of which are regarded as critical and important to the running of the business, as opposed to developing the functionality in-house.

## Risk Profile

Flood Re classifies risks into six key areas (Strategic Risk, Insurance Risk, Credit Risk, Market Risk, Liquidity Risk and Operational Risk).

The Company's most significant Insurance Risk exposure is to losses arising from low frequency, high severity flood events. Reinsurance ceded is placed on both a proportional and non-proportional basis and is the Company's primary mechanism for managing and mitigating Insurance Risk up to the Liability Limit.

In line with Flood Re's design, the premium the Company charges is not reflective of the underlying risk that is assumed. The Company expects that the assumed premium will not be sufficient to cover the estimated mean cost of claims. This deficiency is met by a Levy raised from all insurers writing home insurance in the UK. Coupled with the open market costs of significant reinsurance protection, the resulting net premium income is negative.

The Company's has experienced lower loss activity compared to prior years, in particular relative to that seen throughout the UK during 2020 and 2021. As a result the capital charge for non-life reserve risk has decreased in line with net reserves and now forms a smaller contributor to the overall SCR.

The Company adheres to the Prudent Person Principle through the application of a conservative Market Risk strategy that prioritises capital preservation over investment return. As at 31 March 2022, the Company has invested and liquid assets of £690.9m (2021: £610.7m), representing 88% (2021: 85%) of its total equity and liabilities and 987% (2021: 1,557%) of the Solvency Capital Requirement (SCR).

The Company's maximum exposure to Credit Risk is the gross carrying value of its Levy receivables, reinsurance premium receivables, reinsurance recoveries, trade and other receivables, debt instruments and cash and short-term investments and deposits.

The Company's operating model makes significant use of outsourced service providers to deliver a number of key operational elements. The relationship with, and management of, the outsourced service providers is a key component of the operational risk profile.

The Company has a statutory duty to publish a transition plan, updated on an ongoing basis that sets out how the market will return to risk-reflective pricing post Flood Re in 2039. The first transition plan was published in February 2016 with an update, "The Flood Re Transition Vision", published in July 2018.

The impact of COVID-19 on the risk profile of the Company is highlighted in section C7 with a financial assessment in section D5, noting that the implications and Risk Management focus has shifted to the high inflationary environment as wider first order risks from COVID-19 diminish.

## Valuation for Solvency Purposes

For Solvency II valuation purposes, assets and liabilities are valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction.

Amounts due but not yet received or paid are included in the SII Balance Sheet. Amounts not yet due are included in the cash flows used to calculate Technical Provisions.

Solvency II Technical Provisions are calculated consistent with a probability-weighted average of future cash flows, taking account of the time value of money using the relevant risk-free interest rate and reflect the benefit of the reinsurance programme in place.

Exposure relating to legal obligations is included. An explicit risk margin is added to Technical Provisions.

The Solvency II best estimate includes cash flows from expenses incurred servicing existing policies during their lifetime and are allocated between premium and claims provisions.

The Company does not make use of any matching adjustment (Article 77b), volatility adjustment (Article 77d), transitional risk-free interest rate term structures (Article 308b) or transitional deductions (Article 308d) referred to in the Solvency II Regulations.

## Capital Management

The PIM was approved for use from 1st April 2020 onwards to determine the regulatory SCR. Flood Re now has a PIM as defined in Article 112 of the Solvency II regulations to calculate the regulatory SCR.

As at 31 March 2022, the SCR of £68.2m was calculated using the Partial Internal Model (PIM), as updated for a major model change approved for use from 31 March 2022.

Flood Re's SCR comprises:

- Internally modelled elements, using stochastic and deterministic parameters and methods specifically for:
    - Premium and Catastrophe risk
    - Reserve risk;
    - Counterparty credit risk
    - Operational risk
- Standard formula elements, using prescribed deterministic parameters and/or methods for:
    - Market risk
    - A correlation approach for the aggregation of risk elements.

We model different risk areas separately and then aggregate the modelled outputs to create our overall SCR; this aggregation takes any relationships that exist between different risk types or risk areas into account.

Before building our model, we assessed our business needs and used objective criteria to determine which risk criteria should be included. Our Risk Register was also mapped to our proposed model scope to ensure all relevant and quantifiable risks were captured.

As at 31 March 2022, the Company had available own funds of £615.3m (2021: £492.7m) comprising £579.5m (2021: £471.1m) of basic own funds (tier 1 unrestricted), £1.7m (2020: £2.0m) of deferred tax (tier 3) and £34.1m (2021: £19.6m) of ancillary own funds. The Solvency Capital Ratio as at 31 March 2022 is 900% (2021: 1,251%).

The PRA has re-approved Flood Re to use 50% of the SCR, capped at a monetary amount of £75m, as a method by which uncalled Levy II may be recognised as ancillary own-fund items for the period 1 April 2022 to 31 March 2027 (prior approval was effective for the period from 29 April 2019 to 31 March 2022).

As at 31 March 2022, the Company had an SCR of £68.2m based on the Internal Model (2021: £39.2m). The change in the SCR over the year is driven primarily by a £30.5m increase in Premium Risk offset by a £5m reduction in Reserve Risk, plus a £0.8m increase in Market Risk and £0.7m reduction in Counterparty default risk. See section E for details.

For the years ending 31 March 2022, the Company has complied at all times with the regulatory Minimum Capital Requirements ("MCR") and SCR.

There is no reasonably foreseeable risk of non-compliance with the MCR or SCR and there are no foreseeable dividend distributions.

## Current Operating Environment

The majority of the first order implications of COVID-19 have diminished over the course of 2021/22. Flood Re's operating model, in the latter half of 2021/22 has moved from a fully remote working environment in response to COVID-19 lockdowns to a Hybrid Working Model which seeks to draw on the benefits of both flexible home working and in office cross-team collaboration.

Flood Re recognises the economic environment, both in European and global perspectives with the recovery from the COVID-19 pandemic and the effects of the conflict in Ukraine. The business has no direct exposure to the current conflict, but is impacted by the inflationary consequences. Flood Re has no investment exposure beyond Debt Management Office (DMO) deposits and short-dated UK Gilts.

# Approval by the Board

We acknowledge our responsibility for preparing the SFCR in all material respects in accordance with the PRA Rules and the Solvency II regulations.

We are satisfied that:

a) throughout the financial year in question, Flood Re has complied in all material respects with the requirements of the PRA Rules and the Solvency II regulations, as applicable to the insurer; and

b) it is reasonable to believe that Flood Re has continued to comply subsequently and will continue to comply in future.

**Andy Bord**
**Chief Executive Officer**
**23 June 2022**

**Stuart Logue**
**Chief Financial Officer**
**23 June 2022**

# Audit Exemption

The Company has taken advantage of policy statement PS25/18 Solvency II: External audit of the public disclosure requirement issued in October 2018 by the Prudential Regulation Authority which allows exemption from audit of this Solvency and Financial Condition Report for Flood Re Limited as a small insurer for external audit purposes.

The Company's Auditors, Ernst and Young LLP, have audited the Annual Report and Financial Statements of the Company for the year ended 31 March 2022.

Capital resources and capital requirements are disclosed within Note 6 of the Financial Statements.

# A. Business and Performance

## A.1 Business

**Name and legal form**

Flood Re Limited ("Flood Re" or "the Company") is the Scheme Administrator for the Flood Reinsurance Scheme ("Flood Re Scheme").

The Flood Re Scheme is a joint initiative between the UK Insurance Industry and the UK Government in order to make domestic flood insurance more affordable and available to households in high flood risk areas. The Flood Re Scheme was established by the Water Act 2014 and is expected to be in place for 25 years while the industry transitions to risk-reflective pricing.

Flood Re is a mutual reinsurance company and was incorporated in August 2013 as a private UK Company limited by guarantee.

In accordance with the Government Resources and Accounts Act 2000 (Estimates and Accruals) (Amendment) Order 2015, Flood Re is consolidated into the Department for Environment, Food and Rural Affairs ("DEFRA") annual report and accounts.

The ONS has recently undertaken a classification assessment of Flood Re and they have concluded that Flood Re is classified as a public body, in the central government subsector with effect from 11 November 2015, the date on which The Flood Reinsurance (Scheme Funding and Administration) Regulations 2015 came into force.

The registered office is 75 King William Street, London, EC4N 7BE.

**Supervisory Authorities**

Prudential Regulation Authority, 20 Moorgate, London, EC2R 6DA.

Financial Conduct Authority, 25 the North Colonnade, London, E14 5HS.

**Auditors**

Ernst and Young LLP, 25 Churchill Place, Canary Wharf, London, E14 5EY.

**Qualifying Holdings**

For the year ended 31 March 2022 the following three Ordinary Members have qualifying holdings in Flood Re. Individually they account for 10% or more of the voting rights of Ordinary Members.

- Aviva Insurance Limited
- Lloyds Bank General Insurance Holdings Limited
- Royal & Sun Alliance Ltd

All of the above Ordinary Members write UK Household Insurance business and contribute to the Levy I income and gross written premium assumed by Flood Re.

**Parent and Group undertakings**

None

**Material lines of business**

Flood Re is engaged in the provision of reinsurance cover for a single risk (property), a single peril (flood), single currency (pounds sterling) within a single territory (United Kingdom).

Under Solvency II, all underwriting transactions are classified and recorded under the Proportional Reinsurance – Fire and other damage to property line of business.

**Significant business or events during the period**

While the year was benign, with fewer flooding events in the UK compared to the previous year, the extreme and damaging floods that afflicted Germany further motivated insurers to recognise the value of the Scheme and cede more policies.

Those floods could have easily affected the UK, and the storms that we did experience earlier this year saw very high winds without corresponding levels of rainfall. This will be the nature of climate change. We can be certain that the climate will get warmer and wetter, leading to extreme weather events that will themselves become more frequent and more severe, yet more unpredictable.

The strength of our financial position means that we can be confident in our ability to meet the future needs of households in the UK.

**Quinquennial Review outcome**

In July 2019, we published our Quinquennial Review (QQR) proposals – a series of practical suggestions to improve the Scheme. The Secretary of State supported all but one of the QQR proposals, and confirmed the changes to the Flood Re Scheme on 25 November 2021 and these changes were agreed in Parliament in March 2022.

**Levy I**

The Levy 1 is reduced from £180m to £135m from 1 April 2022, and now aligns to Flood Re's belief that the setting of Levy I should be more flexible to the needs of the Scheme and reflect the prevailing risk profile. Changing the levy setting cycle to three years also aligns it with Flood Re's reinsurance procurement programme.

**Build Back Better**

The most significant development in the year was the support received from Parliament for Flood Re's Build Back Better initiative, which is designed to reduce the cost and impact of future floods by including property resilience measures as part of flood repairs.

This is a major step forward in so many ways. The evidence is there to show how incorporation of such measures will have a profound impact on the reduced costs of future flooding events, but, even more important, on the peace of mind of affected households.

Build Back Better will act as a catalyst to heighten awareness of the importance of property resilience measures and trigger the introduction of a number of future initiatives.

We're confident that, as the year ahead progresses, more insurers will offer Build Back Better as it increasingly becomes a standard component of household insurance.

## A.2 Underwriting Performance

The following underwriting performance analysis is on an International Financial Reporting Standards ("IFRS") GAAP basis as reported in the Statutory Financial Statements for the years ended 31 March 2022 and 2021.

| | 2022<br>£000 | | 2021<br>£000 | | Difference<br>£000 |
|---|---|---|---|---|---|
| Gross written premiums | 46,431 | | 38,772 | | 7,659 |
| Gross change in unearned premium provision | (4,991) | | (2,341) | | (2,650) |
| ***Gross earned premiums*** | **41,440** | | **36,431** | | **5,009** |
| Premium ceded to reinsurers | (69,565) | | (67,456) | | (2,109) |
| Ceded change in unearned premium provision | 3,142 | | 1,676 | | 1,466 |
| ***Ceded earned premiums*** | **(66,423)** | | **(65,780)** | | **(643)** |
| **Net earned premium** | **(24,983)** | | **(29,349)** | | **4,366** |
| **Fees and commission income** | 12,510 | | 11,059 | | 1,451 |
| **Net Insurance claims** | (17,669) | | (4,592) | | (13,077) |
| **Underwriting loss** | **(30,142)** | | **(22,882)** | | **(7,260)** |

Flood Re provides reinsurance cover at a subsidised fixed rate to cedants, resulting in an expected underwriting loss each financial year. The Company reported an underwriting loss for the year ended 31 March 2022 of £30.1 m (2021: loss of £22.9m). The underwriting loss is in line with expectations and is primarily due to:

**Negative net earned premium of £24.9m (2021: Negative £29.3m)**

During the sixth full year of underwriting, Flood Re has grown its book of business and assumed 256,634 policies (2021: 218,090 policies) resulting in an overall gross earned premium of £46.4m (2021: £38.8m). The Company introduced a number of price reductions on 1 January 2019 with the aim of improving affordability of premiums to end consumers at high flood risk. As a result the Gross Earned Premium year on year did increase in line with the number of policies.

**Ceded earned premium has increased by £0.6m to £66.4 m (2021: £65.8m).**

The Company pays a market rate when purchasing outwards reinsurance protection compared to the subsidised premiums it applies to assumed business. Outwards Reinsurance is purchased on a three-year cycle, with the third three-year programme commencing 1 April 2022. The increase in cost shown for the recent procurement reflects Reinsurers' flood risk appetite following the 2021 flooding in Germany rather than increased uncertainty in Flood Re's portfolio at this stage. In addition, the Company is required to purchase reinsurance protection up to the Liability Limit of £2.286bn (£1.9bn from 1 April 2022) and to limit annual losses to a maximum of £100m.

**Commission Income of £12.5 m (2021: £11.1m)**

The Company receives sliding scale commission income on its outwards reinsurance quota share arrangements. Commission income varies with, and is directly related to, the performance of the underlying inwards reinsurance contracts. During the year, the Company experienced lower loss activity than in the prior year. Commission income earns in the same proportion as the ceded premium on the Quota Share.

**Net Insurance claims incurred of £17.7m (2021: £4.6m)**

The increase in gross claims incurred (2022: £32.1m; 2021: £8.2m) largely reflects gross incurred current year claims of £44.6m, which includes the cost of the July 2021 Surface Water Flood claims and the current year prudential margin, offset by prior year reserve releases in this financial year.

The gross loss ratio for the year ended 31 March 2022 was 78% (2021: 23%). Net claims incurred reflect the benefit of the outwards reinsurance programme, specifically the 47.8% Quota Share.

The Company expects that assumed premium will not be sufficient to cover the estimated mean cost of future claims. The gross premium deficiency provision recognises the overall excess of expected claims over unearned premium. During the year, the gross premium deficiency provision has increased to £28.9 m (2021: £17.1m).

## A.3 Investment Performance

The Company has a conservative market risk strategy that prioritises capital preservation over investment return. The investment mandate agreed between the Company, Government and the Insurance Industry restricts the type, duration and amount of holdings that may be invested in. Flood Re only invests in UK Government backed securities (Gilts, Treasury Notes and UK Government backed liquidity funds). Through its anticipated status as a Public Body, Flood Re has access to the UK Debt Management Office (“DMO”) for investment purposes. Short-term deposits with the DMO vary for periods between one day and six months, depending on the immediate cash requirements of the Company.

In addition to deposits with the UK DMO Flood Re’s investment portfolio comprises of investments in UK Treasury Gilts. The debt instruments portfolio as at 31 March 2022 comprised of £17.9m UK Treasury gilts and all invested during Q3 and Q4, of which 6 investments are maturing within the next 12 months and 1 investment in 18 months.

| | 2022<br>£000s | | 2021<br>£000s | | Difference<br>£000s |
|---|---|---|---|---|---|
| Finance Income | 7 | | - | | 7 |
| Interest income on cash and short-term deposits | 341 | | 433 | | (92) |
| Investment management fees | (9) | | - | | (9) |
| **Total investment income** | 339 | | 433 | | (94) |

As at 31 March 2022, the Company had £663.7m (2021: £593.6m) of short-term deposits invested with the DMO, £17.9m was invested in debt instruments and £9.2m (2021: £17.1m) was cash at bank.

For the year ended 31 March 2022, the Company received interest income on cash and short-term deposits of £0.3m (2021: £0.4m). This represents an annualised investment return on average invested assets of 0.05% (2021: 0.07%). For the years ended 31 March 2022 and 2021, the Company has invested in financial assets and recognised unrealised investment losses in equity.

## A.4 Performance of other activities

| | 2022<br>£000 | | 2021<br>£000 | | Difference<br>£000 |
|---|---|---|---|---|---|
| Levy I Income | 180,000 | | 180,000 | | - |
| Levy II Income | - | | - | | - |
| **Total Levy income** | **180,000** | | **180,000** | | **-** |

The Flood Reinsurance (Scheme Funding and Administration) Regulations 2015 and The Flood Reinsurance (Scheme and Scheme Administrator Designation) Regulations 2015 (collectively 'the Regulations') enable the Company, among other matters, to raise an annual insurance industry Levy.

The Levy I has been set out in the Regulations and is payable by UK household insurers. Levy I income for the year ended 31 March 2022 was £180m (2021: £180m). Note that the Levy I income will be £135m from 1 April 2022.

The Company also has the ability to issue a compulsory call for additional funding from the UK household insurers through a Levy II top up mechanism. Levy II contributions received from the Ordinary Members of the Company are initially recognised in a mutual member account within equity. Levy II contributions received from non-members are treated as income in accordance with Levy I.

The Company has not received any Levy II contributions during the years ended 31 March 2022 and 2021.

**Operating and Administrative expenses**

| | 2022<br>£000 | | 2021<br>£000 | | Difference<br>£000 |
|---|---|---|---|---|---|
| **Total operating and administrative expenses** | **18,207** | | **15,692** | | **2,515** |

During the year ended 31 March 2022, the company incurred operating expenses of £18.2m (2021: £15.7m) representing an increase of £2.5m compared to the prior year.

**UK Corporation Tax**

| | 2022 £000 | | 2021 £000 | | Difference £000 |
|---|---|---|---|---|---|
| **Total UK Corporation tax charge (credit)** | **25,065** | | **26,948** | | **(1,874)** |

The UK Corporation Tax charge for the year ended 31 March 2022 was £25.1m (2021: £26.9m) calculated at an effective tax rate of 19% (2021: 19%) on the profit before tax of £131.9m (2021: £141.8m).

## A.5 Any other information

Please refer to page 5 for summary of the impact of COVID-19 on the Company.

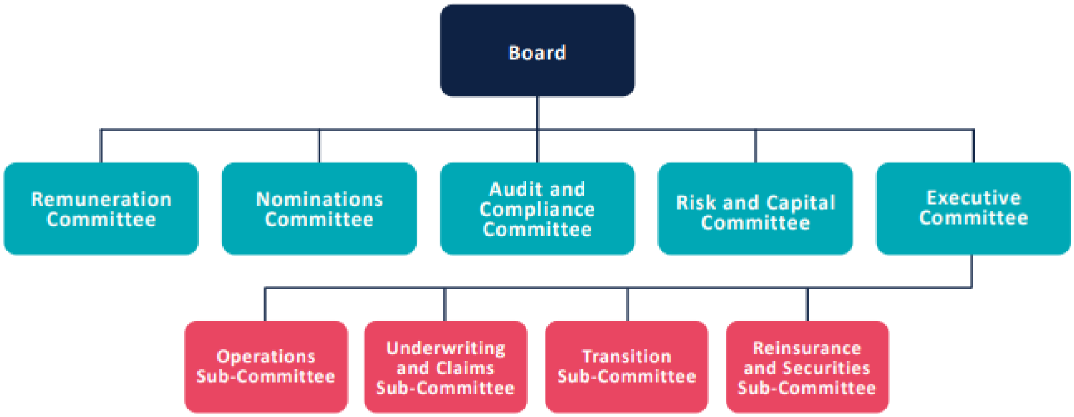
# B. System of Governance

## B.1 General Information on the System of Governance

The System of Governance comprising the Board and Committee composition and structure, fit and proper requirements, internal control system, risk management framework, key function holders and outsourcing arrangements are considered appropriate to the Company given the nature, scale and complexity of the operations. This is reviewed annually through the Board and Committee Effectiveness Review.

### B.1.1 General Information on the System of Governance

The Committee structure as at 31 March 2022 is outlined in the diagram below.




The table below shows the composition of the Flood Re Board and Committees (excluding the Executive Committee).

| Name | Board | Remuneration Committee | Nominations Committee | Risk and Capital Committee | Audit and Compliance Committee |
|---|---|---|---|---|---|
| Mark Hoban | CHAIR | INED | CHAIR | INED | INED |
| Andy Bord | CEO and ED | | | | |
| Judith Eden[1] | INED | CHAIR | INED | INED | INED |
| Huw Evans[2] | SID | CHAIR/INED | INED | | |
| Simon Green[3] | INED | INED | INED | INED | INED |
| David Hindley[4] | INED | INED | INED | CHAIR | INED |
| Claire Ighodaro[5] | INED | INED | INED | INED | CHAIR |
| Paul Leinster | INED | INED | INED | INED | INED |
| Stuart Logue | CFO and ED | | | | |
| Jean Sharp[6] | INED | INED | INED | INED | INED/CHAIR |
| Perry Thomas[7] | INED | INED | INED | CHAIR | INED |

CHAIR = Chair of the Board or Committee, SID = Senior Independent Non-Executive Director, INED = Independent Non-Executive Director, CFO = Chief Financial Officer, CEO = Chief Executive Officer, ED = Executive Director

[1] Judith Eden is the Chair of the Remuneration Committee from 19 March 2021 and was appointed as the Senior Independent Director (SID) at Flood Re with effect from 10 June 2022, subject to regulatory approval.

[2] Huw Evans was the Chair of the Remuneration Committee until 19 March 2021 and Senior Independent Director for period to 31 December 2021. The Board, on the recommendation of the Nominations Committee has appointed Judith Eden to be the Senior Independent Director replacing Huw Evans.

[3] Simon Green was appointed to the Board on 1 January 2022

[4] David Hindley stepped down as Chair of the Risk & Capital Committee and resigned from the Board effective 31 December 2021.

[5] Claire Ighodaro stepped down as Chair of the Audit and Compliance Committee and resigned from the Board effective 30 June 2021.

[6] Jean Sharp was appointed to the Board on 1 April 2021 and chaired the Audit and Compliance Committee from 1 July 2021.

[7] Perry Thomas was appointed to the Board on 1 January 2022 and has chaired the Risk & Capital Committee from 11 January 2022.

### Board

The Flood Re Board maintains overall responsibility for the governance of the Company, setting strategic aims and providing the leadership to put them into effect within the scope of Flood Re's Articles and the powers that the Company has been granted under the Water Act 2014, the Flood Reinsurance (Scheme Funding and Administration) Regulations 2015 and the Flood Reinsurance (Scheme and Scheme Administrator Designation) Regulations 2015 (collectively 'the Regulations'). The Board also oversees the running of the following Committees:

#### Remuneration Committee

Flood Re's Remuneration Committee is responsible for setting the remuneration of the Executive Directors and Chair and overseeing Flood Re's overall Remuneration Policy. Fees for the Chair and other Independent Non-Executive Directors are determined annually by the Remuneration Committee and approved by the Board. The Committee oversees the remuneration including bonus structure and alignment to the Flood Re desired behaviours and objectives.

#### Nominations Committee

The Nominations Committee reviews the structure, size, and composition (including the skills, knowledge, experience and diversity) required of the Board and makes recommendations to the Board with regard to any changes. The Committee continues to actively monitor succession planning for Directors and other Senior Executives across the organisation.

Creating an inclusive environment where all types of diversity are valued is important to the Company and underpinned by the Company's Desired Behaviours and High-Performing culture. The Company has committed to the Women in Finance Charter with the pledge to make changes to improve gender diversity within the senior levels of the organisation. In 2021 we achieved our first Women in Finance Charter target early and increased female representation on our Executive Committee from 12.5% to 25% (with the arrival of Andrea Santolalla). As of 1 March 2022, there are eight members of the Executive Committee – three are female and five are male (37.5% v 62.5%). Whilst we are delighted with the progress we have made so far, we have further to go to achieve gender balance across the senior levels of the Company. We have therefore set a further Women in Finance Charter target to achieve at least gender parity on the Executive Committee by 2024.

The Board, on 10 June 2022 on the recommendation of the Nominations Committee has appointed Judith Eden to be the Senior Independent Director, subject to regulatory approval.

**Risk and Capital Committee (RCC)**

The RCC is responsible for the oversight of the risk management framework and capital adequacy; ensuring that all risks to the Company are identified, assessed, and monitored in line with the risk appetite and policies. During the year, the RCC has continued to focus in particular on Flood Re's Internal Model Application to the PRA and on its consideration of Flood Re's key strategic risks relating to the Scheme's Transition Plan and Quinquennial Review.

**Audit and Compliance Committee (ACC)**

The ACC is responsible for acting independently from Flood Re's Executive Committee to ensure that the interests of Members and stakeholders are properly protected in relation to financial reporting and internal control. The ACC has oversight of the internal and external audit arrangements and the management and monitoring of Flood Re's capital position. The ACC also oversees legal, regulatory and compliance matters. It also ensures that public money is handled and reported in line with Governmental requirements for the prudent stewardship of financial resources. The Audit and Compliance Committee Chair is the whistle-blowers' champion for Flood Re.

The Committee also has oversight of Flood Re's adoption of International Financial Reporting Standard 17: Insurance Contracts, which will be effective for the financial year commencing 1 April 2023.

**Executive Committee (ExCo)**

The Executive Committee is responsible for the day-to-day running of the Company and oversees the running of its Sub-Committees. There are four Sub-Committees in total:

- Reinsurance and Securities Sub-Committees: responsible for oversight on reinsurance counterparties and related activities
- Operations Sub-Committee: responsible for Flood Re's operational activities
- Underwriting and Claims Sub-Committee: responsible for oversight of underwriting activities
- Transition sub-committee responsible for Flood Re's successful, sustainable and affordable transition in 2039 and beyond.

### B.1.2 Changes in the System of Governance

There were no changes to the system of governance during the year.

### B.1.3 Remuneration Policy

The Remuneration Committee meets twice a year: in February to set policy decisions, approve the renewal of staff benefit schemes and to set the budget for pay increases, and in May to accept or amend recommendations for pay and bonuses from the CEO.

Flood Re's Remuneration Policy and practices reflect its objectives of good corporate governance and sustained, long-term value to industry participants and the need to attract and retain talent with suitable experience. The Remuneration Policy and practices also aim to promote robust and effective risk management. Flood Re's Remuneration Policy applies to all employees.

The Remuneration Policy is owned by the Remuneration Committee. It is reviewed by the Remuneration Committee at least annually and sent to the Board for approval. This helps ensure it remains appropriate and relevant. The general principles of the Remuneration Policy are as follows:

- Flood Re provides total remuneration packages delivered through fixed and variable pay components. Fixed remuneration is determined based on the role and position of the individual employee and reflects the need to meet the threshold conditions set by Regulators and to attract individuals with the requisite experience and expertise to operate in a highly regulated environment. Factors affecting this will include professional experience, responsibility, job complexity, and local market conditions

- Performance-based bonuses are in place and are intended to motivate and reward high performers who significantly contribute to the Company's achievements and results and out-perform their individual objectives, including behaviours, and those set for the Company as a whole. The performance-based bonus is in the form of a cash settlement capped at a maximum of 30% of base salary (dependent on the role and seniority of the employee within the organisation). Given the unique ownership of Flood Re there are no shares nor share options included in the performance-based bonus

- Flood Re offers all employees access to a Defined Contribution Pension Plan

- The Company aims to provide total remuneration packages that reward superior performance in a way that is consistent with the Company's values and culture and is appropriate for its ownership structure.

The Remuneration Committee determines the performance-based remuneration of the Executive Committee along with the performance-based remuneration pool available for allocation by the CEO to all other staff.

Fees for the Chair and other Independent Non-Executive Directors are determined annually by the Remuneration Committee and approved by the Board.

The Chair and other Independent Non-Executive Directors are not eligible to participate in annual bonus plans, the employee benefit schemes or the pension scheme. Their pay rates are determined annually, with changes based upon inflation, by the Remuneration Committee and approved by the

Board after taking advice from the CEO. The Remuneration Committee takes into account the time commitment, the responsibilities and complexities of their roles, as well as the rates paid by other comparable organisations within the insurance industry and the wider financial services sector, undertaking external benchmarking activities.

### B.1.4 Directors' Remuneration disclosures

The table below shows the total compensation of Directors and Non-Executive Directors for the years ended 31 March 2022 and 2021.

| | 2022<br>£000 | 2021<br>£000 |
|---|---|---|
| Short-term employee benefits | 1,198 | 1,199 |
| Pension allowance | 59 | 55 |
| Pension and taxable benefits | 13 | 13 |
| **Total Directors' emoluments** | **1,270** | **1,267** |

Pension contributions represent 10.5% of base salary. Executive Directors were eligible to join the defined contribution pension scheme from 1 January 2016.

The Directors and Officers of the Company have the benefit of insurance which provides suitable cover in respect of legal actions brought against them.

### B.1.5 Other related party transactions

**Department of Environment, Food and Rural Affairs**

In accordance with the UK Government Resources and Accounts Act 2000 (Estimates and Accruals) (Amendment) Order 2015, the information contained in the Company's Annual Report and Accounts is consolidated into the Annual Report and Accounts of the Department for Environment, Food and Rural Affairs ("DEFRA"). In 2021/22 the Company was formally designated as a non-departmental Public Body by the Office for National Statistics and the classifications became public on 23 December 2021.

### B.1.6 Ordinary members

Through its normal course of business, a number of transactions are by necessity undertaken by the Company with its Ordinary Members:

- Levy income: underwriters of UK household insurance business are required to contribute to the Company annual Levy in proportion to their relevant underwriting profiles
- Gross written premium and associated claims: if signed up to the Company's standard inwards reinsurance treaty, underwriters of UK household insurance business may cede the associated flood peril in relation to their inwards policies to the Company

- Outwards reinsurance ceded premium and associated technical balances: through a public procurement process subject to the UK Government's public procurement process, the Company places its outwards reinsurance programme on the global reinsurance market
- Commercial insurance: Ordinary Members participate on the commercial insurance coverage purchased by the Company.

All transactions are entered into on arm's length terms and are considered by Company management to be market sensitive.

For the years ended 31 March 2022 and 2021, the following three Ordinary Members individually account for 10% or more of the voting rights of Ordinary Members:

- Aviva Insurance Limited
- Lloyds Bank General Insurance Holdings Limited
- Royal & Sun Alliance Insurance Ltd

The above Ordinary Members write UK household insurance business and contribute to the Levy I income and gross written premium assumed by the Company and may also provide commercial insurance services.

### B.1.7 Directors and Officers shared with other entities

In the normal course of its operations, the Company has entered into transactions with companies whose directors and officers include directors or non-executive directors of the Company. All such transactions entered into were completed on market terms.

Simon Green is an Independent Non-Executive Director, and is also a Non-Executive Director of Arthur J. Gallagher, Chair of the Risk Committee and Chair of Pen Underwriting Limited. His career was in banking and financial services regulation as a senior regulator at the Bank of England, FSA and FCA.

Perry Thomas, is an Independent Non-Executive Director, and chair of Risk and Capital Committee in Flood Re. Perry held directorships in the UK, Bermuda, Ireland, India, South Africa, Malta and Luxembourg, and was on the Council of the Institute and Faculty of Actuaries. He is a Non-Executive Director with PlanetWatchers and the British Friendly Society Limited.

Jean Sharp, is an Independent Non-Executive Director, is also chair of the Audit and Compliance Committee in Flood Re. She is also an independent non-executive director at Personal Assets Trust plc and FBD Holding plc (an Irish insurance group). She spent over 20 years in financial services with Aviva plc and is a former partner with EY. She is a chartered accountant.

Claire Ighodaro was an Independent Non-Executive Director until 30 June 2021, and at the time, Non-Executive Chair of Axa XL's UK entities and previously Non-Executive Chair of XL Insurance Company SE. Axa XL's UK entities and XL Insurance Company SE underwrite household insurance business in the UK and provide flood-related reinsurance protection.

Huw Evans was the Senior Independent Non-Executive Director until 31 December 2021, and Chair of the Remuneration Committee until 19 March 2022, and was Director General at the Association of British Insurers (ABI) until December 2021. For the year ended 31 March 2022, the Company incurred £71.7k (2021: £60k) of ABI associate membership fees.

## B.2 Fit and Proper requirements

The Company ensures that individuals performing a role requiring PRA approval meet the Fit and Proper requirements at all times to ensure that they have the appropriate competence, expertise, and propriety to carry out their roles. This has been reviewed in line with the newly implemented Senior Managers and Certification Regime.

The Company assesses Fit and Proper requirements initially during the recruitment process and subsequently throughout the period of employment. A more granular and role specific analysis is conducted prior to the appointment of an approved person due to the critical nature of the role in terms of the ongoing soundness of the Company and protection of policyholders.

During the recruitment phase the Company will:

- Use specialist and experienced recruitment agencies
- Assess applicant competence against job descriptions and key functional requirements
- Involve ExCo members, Directors and Non-Executive Directors in the interview process as appropriate
- Perform regulatory reference checking covering six years
- Verify professional and educational qualifications
- Conduct criminal record checks
- Complete identity and address verification checks
- Search FCA/PRA registers
- Undertake financial sanctions and anti-money laundering checks.

During the period of employment, the Company will:

- Complete an induction programme
- Conduct bi-annual performance appraisals
- Review job descriptions and delegated authorities
- Maintain a Management Responsibilities map with clearly defined roles
- Monitor actual performance against role requirements, specific targets, objectives, desired behaviours and quality outputs
- Conduct role specific training to ensure technical and non-technical competence
- Conduct compulsory compliance training for all staff
- Fully investigate any breaches or incidents
- Maintain an appropriate Board and Committee structure.

All staff are made aware of and are expected to comply with their specific regulatory obligations. All staff are expected to notify the Company of any change in circumstances impacting on their fitness and propriety. The Senior Managers and Certification Regime ("SM&CR") came into force on 7 March 2016, replacing the previous Approved Persons Regime. Flood Re has a suite of documents which together reflect the required "Management Responsibilities map", comprising an organisational chart, a Committee structure (showing membership and terms of reference) and job descriptions for all SMF and Key Function holders and individuals with Prescribed Responsibilities.

## B.3 Risk management system including the own risk and solvency assessment

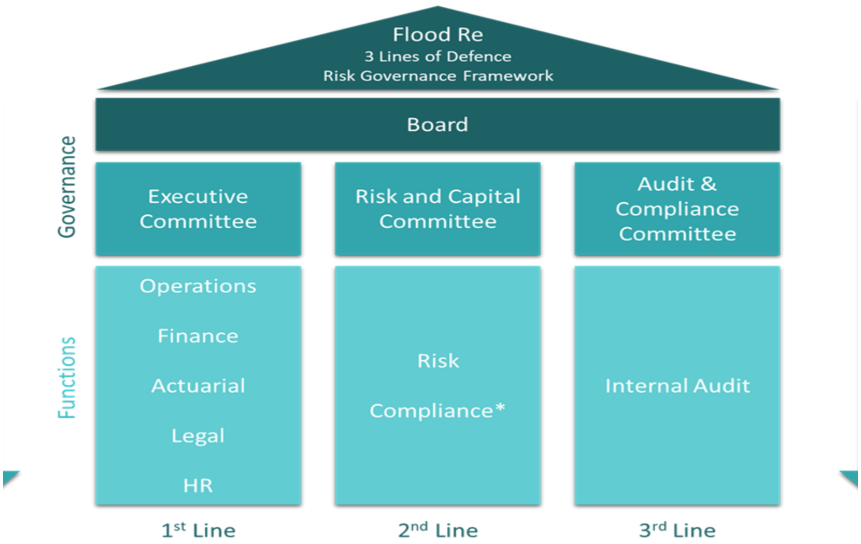
**Overview of risk**

Flood Re defines risk as the possibility of incurring misfortune or loss. In principle, a risk is expressed by the combination of the probability (likelihood) of an event and its impact. Uncertainty occurs where it is not possible to assess the probability and/or impact with sufficiently reliable accuracy. Flood Re classifies risks into six overarching areas (Strategic risk, Insurance risk, Credit risk, Market risk, Liquidity risk and Operational risk). Flood Re's principal risks and how they are managed or mitigated are set out in Note 5 of the Notes to the Financial Statements.

**Risk governance and culture**

Ultimate responsibility for risk management within Flood Re lies with the Board. Critical to this is the tone it sets with respect to Risk Culture. The Board's responsibility for risk management is discharged through Flood Re's Committee structure (see Directors' report – governance framework).

Flood Re uses the UK financial industry's standard three lines of defence approach to managing risks:




**The first line of defence** is undertaken by the Executive Team and staff of Flood Re. Its responsibility is to identify and manage risks (mainly through operating mitigating controls), generate and review risk information, and to take appropriate action where necessary to maintain Flood Re's risk exposure within risk appetite. The first line of defence reports to the Executive Committee and the Risk function on its management of current and forward-looking risk exposures.

**The second line of defence** is carried out by the Risk function, led by the Chief Risk Officer and the Legal and Compliance function led by the General Counsel.

The Risk function is responsible for providing risk advice, facilitating and co-ordinating first line risk activity, monitoring risks and providing independent commentary, oversight, and challenge of the management of risks and Internal Model validation. The Risk function reports to the Risk and Capital Committee ("RCC").

The Legal and Compliance function forms an independent part of the second line of defence and is responsible for implementing a governance framework across the Company, compliance monitoring, regulatory disclosure and monitoring potential Legal and Compliance risk arising from the activities of Flood Re's outsourced service providers. The Legal and Compliance function reports to the Audit and Compliance Committee ("ACC").

**The third line of defence** is performed by the Internal Audit function which evaluates the effectiveness of the design and operation of Flood Re's control environment and reports to the ACC. Its responsibility is to evaluate whether the controls and risk information determined as required by the first line of defence (in conjunction with the second line) are adequate and effective in mitigating risk to the Board-agreed risk appetite levels.

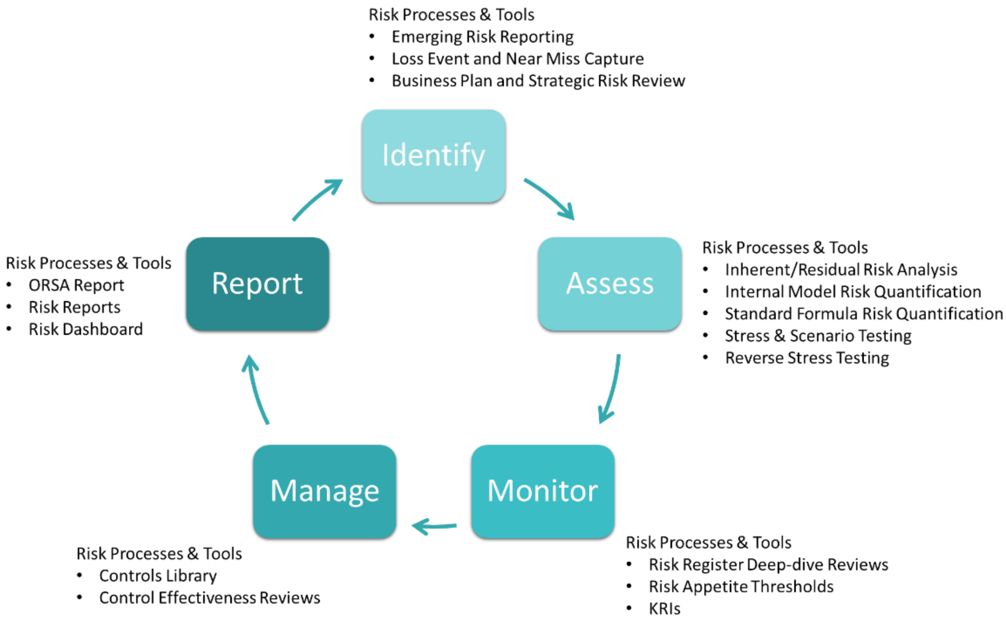
It is the responsibility of each of the three lines of defence to ensure the delivery of Flood Re's complete risk management system..

**Risk management system**

The following diagram sets out the major risk management tools and procedures that make up Flood Re's risk management system.

Each of the processes and tools utilised in the risk management system – in particular the internal model, risk appetite framework and stress and scenario testing – feed into Flood Re's wider business strategy and decision-making processes.

Recent examples of these elements of the risk management system being used for major strategic decisions and direction include development and design of the three-year reinsurance programme and setting Levy 1 in line with risk appetite thresholds and responding to and managing external stresses from COVID-19 and the escalating inflationary environment.




**Risk register**

Flood Re operates a live risk register containing all identified and emerging risks at a given date.

Each risk on the register is subject to an assessment of both its likelihood (of occurrence) and impact (given occurrence). Flood Re monitors changes in its risk profile against a set of Key Risk Indicators (KRIs) and Board-approved risk appetite metrics on an ongoing basis.

Each risk is allocated to a risk owner. Risk owners ensure risks are managed in accordance with the Risk Management Policy and within the risk appetite metrics. The management of each risk is aligned to one or more of the following types of actions: transfer, avoid, reduce, or accept.

Control effectiveness reviews are used to monitor the design and performance of risk controls. Regular risk management information (e.g., position versus appetite, KRIs) is reported to each risk owner to ensure that risks are being monitored. A CRO report summarises this activity and is delivered to the RCC on a quarterly basis.

***Partial Internal Model Governance***

The Flood Re Internal Model Governance framework is used to ensure there is a robust structure around the operation and modification of the Internal Model.

Flood Re maintains a ‘three lines of defence’ model in its approach to risk management; application of this framework to the Flood Re Internal Model is described below:

| **First line of defence**<br>Risk management and management control | **Second line of defence**<br>Risk oversight, policy and methodologies | **Third line of defence**<br>Independent assurance |
|---|---|---|
| • Risk owners<br>• Internal controls<br>• Function managers<br>• First-line groups and committees | • Risk and Capital Committee<br>• Risk function | • Co-sourced to an external provider<br>• Audit and Compliance Committee<br>• External/Internal audit |

***Roles and responsibilities***

| Role | Responsibilities |
|---|---|
| Board | Responsible for the continuous, proper operation of the Flood Re Internal Model in all respects, including approving applicable policies. Responsible for approving Major Model Changes before submission to the PRA. |
| Risk and Capital Committee | Responsible for second line oversight, including risk management and capital modelling. Provides oversight of the Internal Model scope, design, calibration and use. Ensures the Internal Model is appropriately validated in line with the IM Validation Policy, including signing off the scope of independent model validation cycles and the accompanying key findings. |
| Executive Committee | Responsible for first line activities, including the assessment and monitoring of reserving, underwriting/claims oversight, investments and the governance of changes to the Internal Model. |
| Chief Actuary | Primary responsibility for the production and routine maintenance of, and reporting from, the Internal Model. |
| Responsible Executives | The Chief Financial Officer and Director of Operations work with the Head of Capital to ensure the Internal Model is appropriately designed and calibrated to reflect all material and quantifiable risks identified in the Risk Register. |
| Risk Function | Responsible for review and challenge of the assessment of individual risks within the Internal Model through the Independent Validation Framework. |
| Internal Audit | Provides the Board with independent challenge and assurance around the governance of the Internal Model and adherence to the Internal Model Governance Policy. |

***Material changes to the internal model governance during the reporting period***

There have been no material changes to the governance of the Internal Model during the year. Changes to the Internal Model are directly under the remit of the Executive Committee team with ongoing oversight by the RCC as set out above. The Board ultimately approves the SCR alongside major model changes as they are delivered. In 2022/23 Flood Re plans to formally set up a sub-committee of the ExCo (the Model Oversight Group), to manage the lower-level monthly oversight of the PIM.

***The Partial Internal Model validation process***

The suitability of the design, methodology and outputs of our Partial Internal Model is determined through the model validation process which includes:

- The performance of first-line testing of the model outputs using a range of top-down (e.g., to review how the board gain comfort with key aspects of the model and key results) and bottom-up (e.g., reviewing detailed justification of individual assumptions) perspectives.
- Using the model and determining how appropriate it is in a business context
- Independent model validation by the Risk Function (with external third-party support as required) of the model to assess its scope, appropriateness and compliance with SII requirements.

The validation process is designed to help the board and its committees:

- Understand how the methodologies and processes support the continuing appropriateness of the model
- Understand the robustness of the model governance.
- Guard against the risk of model drift.
- Challenge key assumptions and understand the sensitivity of the model results to these.
- Prioritise future development of the model in light of proportionality and impact on the use of the model.

Model testing includes reasonableness checks, variation of assumptions and parameters (sensitivity analysis), risk ranking and scenario testing, as described in section C.

***Internal Model Risk Coverage and Appropriateness***

The tools Flood Re uses to continuously assess Risk Coverage and Appropriateness are broadly aligned to the following activities:

- Model Use - Using model output for decision making is a key tool for testing its appropriateness. The “feedback loop” following model use ensures any limitations or gaps in risk coverage are identified for remediation
- Model Validation - The various tools used to validate the partial internal model are key to identifying potential gaps in the model scope (e.g., material risks which are not being modelled).
- Risk Register and wider Risk tools - The ongoing review and maintenance of the Risk Register highlights potential limitations in the scope of the model, particularly where emerging risks are being identified.

Own Risk and Solvency Assessment (ORSA) – Through its forward-looking assessment of non-modelled risk, it is key in assessing the ongoing appropriateness of model scope.

**ORSA Policy & Assessment of Capital Requirements**

The ongoing delivery of the risk cycle, and its associated processes and procedures, ultimately culminates in the completion of the Own Risk and Solvency Assessment (ORSA) Report.


The ORSA Report seeks to draw together Flood Re's risk and capital management processes to facilitate understanding of its current and forward-looking risk profile and ultimately inform strategic decision-making. The forward-looking element of the ORSA is inherently linked with Flood Re's business planning process. The ORSA report sets out both Flood Re's regulatory Solvency Capital Requirement on both its PRA-approved Partial Internal Model basis and against the Standard Formula.

The Standard Formula is a generic tool for assessing a firm's solvency capital requirement and given the unique nature and structure of the Scheme, in a number of areas it does not adequately capture Flood Re's risk profile. As such a Partial Internal Model was developed and has been reported in the ORSA as our view of capital since the PIM received regulatory approval for application on 1 April 2020.

The ORSA report considers the current and forecast solvency position of the Flood Re Scheme against our defined Capital Risk Appetite metrics, and contemplates a number of stresses and scenario tests to determine the mitigating actions and level of capital to be held in order to absorb crystallised risks.

The ORSA report is owned by the CRO and delivered at least annually by the Risk team, with considerable involvement from Actuarial, Operations and Finance. It is approved by the Board, with an ultimate audience of the Board, Executive Committee, Employees and Regulators.

A material change in the risk profile of the Company would trigger elements of the ORSA process outside of the annual cycle. The Executive Committee, advised by the CRO, would be required to make a judgement on materiality. Examples of a material change include:

- Unforeseen change in SCR or risk component commensurate with the major model change threshold
- Significant change to the business plan e.g. new perils, change in reinsurance strategy, corporate actions, changes in operating model such as outsourcing arrangements.

## B.4 Internal control system

### B.4.1 Internal control system

Compliance Risk is defined as the risk of legal or regulatory sanctions, material financial loss or reputational loss to Flood Re as a result of not complying with laws, regulations and administrative provisions.

The Board has ultimate responsibility for compliance and ensuring that an appropriate internal control system is in place and operating effectively throughout the organisation. The internal control system of the Company broadly comprises

- An appropriate Board and Committee structure for the nature and scale of the Company (see Section B.1 above)
- Enterprise risk management framework (see section B3 above)
- Key function holders including a Compliance function holder responsible for Compliance Risk (see B.4.2 below);
- Committee terms of reference
- Clearly defined roles and responsibilities for all staff members
- Ongoing training for all staff
- Policies and Procedures covering all significant areas of applicable law and regulation
- Annual Board and Committee Effectiveness Review.

**Terms of Reference**

The Board approves terms of reference for each Committee and Sub-Committee of the Company, subject to annual review and approval. Terms of reference outline the Committee structure and composition, roles and responsibilities of individuals, monitoring and oversight responsibility of the Committee or Sub-Committee, the overarching operating principles guiding the Committee, the required frequency of meetings, monitoring requirements and governance requirements (e.g., quorums and voting rights).

**Roles and responsibilities (See also section B.2 above)**

All employees have clearly defined job descriptions and delegated authorities. These are reviewed annually for appropriateness and particularly with the implementation of the Senior Managers and Certification Regime. All staff must adhere to the requirements of the Flood Re Compliance Framework and Procedures. An annual compliance attestation is required from all staff. Directors and Key Function holders are responsible for the enforcement of compliance procedures in each of their respective areas of activity.

**Training and competence**

Flood Re has a formal performance monitoring and assessment framework to ensure that all staff are competent and appropriately supervised. All staff are assessed against Company, department and role specific objectives as part of the annual appraisal process. The appraisal process identifies training and development needs, particularly reflecting the requirements of the Senior Managers and Certification Regime.

Annual regulatory, compliance and anti-financial crime training is provided to all staff on a compulsory basis to ensure that they are aware of their regulatory responsibilities.

Employees attend relevant industry training and undergo continuing professional development to keep them abreast of industry developments.

**Policies and Procedures**

The Company maintains policy and procedure documents for all significant areas of legal and regulatory risk and operations. All Level 1 Policy documents are subject to final review and approval by the Board on an annual basis. All activities of the Company are managed in accordance with the documented policies and procedures. Policy documents are available to all staff on an intranet website.

### B.4.2 Compliance Function

Flood Re has a Compliance Function headed by the General Counsel who reports directly into the CEO and the ACC. The Compliance Function forms an independent part of the second line of defence (see section B.3). The General Counsel has rights of access to all records, documents and procedures of the Company. All employees must co-operate to the best of their ability with the Compliance Function.

The Compliance Function has responsibility for the following:

- Providing guidance and training on the proper application and interpretation of law, regulatory principles, rules, guidance, internal policies and codes of practice
- Maintenance of the Framework and Procedures issued to all staff including establishing procedures around anti-financial crime, data protection, conflicts of interest, treating customers fairly, whistleblowing and complaints handling
- Ensuring each business area documents their Policies and Procedures to a common compliant standard with appropriate annual review and approval
- Overseeing eligibility of ceded policies and claims, in accordance with the Regulations

- Conducting risk-based compliance monitoring in accordance with a plan approved by the ACC
- Monitoring compliance risk arising from activities of outsourced service providers through regular client meetings and reviews of Risk and Compliance processes and manuals at the service provider (see section B.7 below)
- Maintenance of an incident log
- Managing the firm's supervisory relationships with its regulators and arm's length government body
- Disclosing to the Regulatory Authorities anything relating to the firm which the regulator would reasonably expect notice of (e.g., Breaches, Solvency adequacy)
- Ensuring that Flood Re acts within the U.K. Government's public procurement process requirements when awarding all major contracts
- Overseeing the governance of Board and Committee meetings (minutes, voting rights, attendance records, notice periods, terms of reference etc.)

**Responsible Officer**

The Company's Responsible Officer has direct accountability to Parliament for the achievement of the policy objectives set out in the Regulations and must pay due regard to the need to act in the public interest. The Chief Executive Officer is the designated Responsible Officer, supported by the Flood Re Board.

## B.5 Internal audit function

Flood Re has an Internal Audit function headed by a Chief Internal Auditor. In addition to internal resources, the function utilises external service providers for some of the audit work, especially in cases where specialist skills are required.

The Internal Audit function holder has a documented standard procedure that is aligned to the Internal Audit Standards set out by the Chartered Institute of Internal Auditors ("IIA").

The Internal Audit function carries out a risk based annual planning process, which ensures that areas of high risk are given more priority compared to low risk areas. The audit planning is structured to ensure that each area is audited at least once every three years. The appropriateness of the plan is regularly reviewed and where necessary, changes are proposed and presented to the ACC for approval.

All audit actions identified through audits are tracked to ensure appropriate and timely resolution of issues. A quarterly Internal Audit Report is presented to the ACC. This report includes a summary of the results of audits carried out in that quarter, progress in resolving outstanding issues and an overall view on the control environment. In addition, an Annual Internal Audit report is produced summarising the key issues identified in internal audit through the year and how these issues were resolved.

### B.5.1 Independence and objectivity

The Flood Re Internal Audit function ensures independence and objectivity in a number of ways:

*Reporting Lines:* The Chief Internal Auditor reports to the Chair of the ACC to ensure independence. Administratively, the Chief Internal Auditor works with the CEO to ensure that all key areas of the business are given adequate attention.

*Responsibility:* The Chief Internal Auditor does not have management responsibility over any areas that are subject to internal audits. In any cases of potential conflict, safeguards are put in place to preserve independence.

*Scope of Work*: The work of Internal Audit is governed by an Internal Audit Charter which specifies that Internal Audit should have unlimited access to all areas of the business.

*Approach:* All audits are conducted in line with a standard internal Audit methodology that is aligned to the IIA standards. These standards require Internal Audits to be carried out objectively and where necessary, additional measures to be in place to avoid any conflict of interest.

## B.6 Actuarial function

The Actuarial Function forms part of Flood Re's System of Governance, working alongside the Risk Management Function, the Compliance Function and the Internal Audit Function.

The Actuarial Function delivers consistent and reliable analysis and recommendations for all areas of the business, on both a regular and ad-hoc basis. The Actuarial Function is responsible for the following:

- Calculating and recommending quarterly IFRS best estimate reserves
- Calculating and recommending quarterly Solvency II Technical Provisions
- Calculation of the Solvency Capital Requirement
- Parameterisation and operating of the Internal Model, including assessing and recommending the Solvency Capital Requirement
- Flood intelligence and exposure management
- Assessment of Levy, inwards tariff premiums and Liability Limit appropriateness
- Production of analysis from the capital model that facilitates model use as detailed within the Flood Re Model Use Policy, including reinsurance analysis
- Provision of the Actuarial Function Report including the opinions on the adequacy of the Technical Provisions, underwriting policy and reinsurance arrangements.

The Actuarial Function is led by the Chief Actuary, who is a qualified Actuary and holder of the Institute and Faculty of Actuaries (IFoA) Chief Actuary Certificate. The Chief Actuary reports directly to the Chief Financial Officer and the RCC.

Potential conflicts of interest are mitigated by the following:

- Clear segregation of responsibilities where the Actuarial Function is independent from the Risk Management Function.
- The Chief Actuary reports directly to the CEO which allows key messages of the Actuarial Function to be communicated directly to the Board.

- The review process ensures appropriate checking and that peer reviews are in place, with clear reporting lines within the Actuarial Function.

Actuarial processes are carried out in accordance with regulatory expectations and Technical Actuarial Standards ("TAS"). The TAS standards allow for a proportionate approach when addressing these standards, dependent on the nature of the work and significance of the areas concerned for the business. "Reserved work" such as recommending reserve levels, assessing capital requirements or establishing frameworks for regular work are carried out under full TAS standards.

## B.7 Outsourcing

### Outsourcing

Flood Re's design and business strategy requires a number of operational outsourcing arrangements, some of which are critical or important to the running of the business, as opposed to developing the functionality in-house. The table below provides an overview of the critical and important outsourcing contracts the Company has entered into:

| Contract | Description | Jurisdiction | Responsibility |
|---|---|---|---|
| Capita Plc | General reinsurance management services including underwriting, claims management and IT Infrastructure | UK | Director of Operations |
| Guy Carpenter | Support in relation to catastrophe modelling, geo-coding and capital modelling. | UK | Chief Actuary |
| Watertrace Limited | Bordereaux Management | UK | Director of Operations |
| AddressCloud Limited | Reinsurance management services | UK | Director of Operations |

The Outsourcing Policy is owned by the Director of Operations. It is reviewed by the Director of Operations and the Operations Sub-Committee at least annually and approved by the Board. This helps ensure it remains appropriate and relevant. Additional reviews may be performed as required and as detailed in the Documentation Policy.

The key components and principles of the Outsourcing Policy, which forms part of the overall risk management strategy, are as follows:

**Risk Appetite**

Board approved risk appetite statements define the level of Operational Risk the Company is willing to accept through outsourcing. The risk appetite is used to ensure outsourcing is managed in line with acceptable risk thresholds.

**Governance and oversight**

Each outsourced activity is assigned to a contract owner who has responsibility for monitoring the day-to-day activities of the outsourced arrangement.

The Director of Operations is primarily accountable for the oversight of the outsource providers and their performance in line with service level agreements and key performance indicators. The General Counsel retains responsibility for all compliance matters in relation to the outsource providers and works with the Director of Operations to ensure that outsourced service providers comply with Flood Re's policies and procedures.

The Operations Sub-Committee is responsible for overseeing outsourcing performance. This Sub-Committee is chaired by the Director of Operations and reports into the ExCo.

**Define business needs and develop outsourcing strategy**

Prior to entering into an outsourcing arrangement, the contract owner must define the scope of Flood Re's outsourced needs and identify all of the stakeholders within the Company that will need to be engaged through the entire process. A risk and impact assessment on the overall business strategy is completed.

**Perform due diligence**

Due diligence is performed prior to entering into outsourcing arrangements and at regular intervals thereafter (at least every three years). Due diligence includes, but is not limited to, consideration of strategic fit of the service provider with Flood Re, experience and technical expertise, financial strength, business reputation, internal control environment including confidentiality provisions, business continuity, reliance on sub-contractors, ability to provide services over the longer term and degree of insurance coverage.

**Procurement**

The Company procures services in line with its Board-approved procurement policy which, where necessary, requires us to comply with public procurement rules. The procurement policy in place, as well as the legal framework for public procurement, ensures that contracts are awarded fairly, transparently and without discrimination. The Company is required to advertise the contract by means of the U.K. Government's public procurement process when awarding all contracts above the public procurement thresholds; and to follow specified procedures for selecting candidates and assessing tenders.

**Contractual arrangements**

All contracts are reviewed by the Legal and Compliance team prior to being signed to ensure that the minimum required terms and clauses are included. To ensure that all regulatory and legal requirements are met, an outsourcing contract review checklist must be completed prior to binding the Company to any contract.

All contracts are recorded in a Contracts Log, maintained by the General Counsel.

**Monitoring and review**

The performance of the third party service providers is monitored on an on-going basis through the provision of management information and regular review meetings by the Operations Sub-Committee and the Executive Committee.

**Retained capability**

Where a business activity is outsourced, the Company remains responsible for all of its regulatory obligations, as these cannot be contracted out. Flood Re must retain the necessary expertise to supervise the outsourced service effectively and to manage the risks associated with the outsourcing, and must supervise those functions and manage those risks.

**Termination**

The Company is required to have exit plans in place for all critical outsourced functions. Exit plans form part of the Company's resilience arrangements and must be developed and maintained in consultation with the service provider and reviewed annually.

Flood Re is re-designing its operational model to ensure it is fit for purpose for the future evolution and advancement of the Scheme. This involved re-procurement of several outsourced services during the 2021-22 financial year which will move into production in the financial year 2022-2023.

## B.8 Any other information

Risk assessment is described in section C with a financial assessment in section D.

# C. Risk Profile

The following section sets out the major elements of the Flood Re Risk Profile, which are managed through the risk cycle and ultimately presented in the ORSA report. The SCR for Flood Re is calculated using a Partial Internal Model. The basis of each of the standalone capital charges is given in the relevant sub-section below.

## C.1 Insurance risk

**Premium**

As at 31 March 2022, the undiversified Premium Risk capital charge is £34.5m (2021: £4.0m). The capital charge for this risk is calculated using the Partial Internal Model.

Premium Risk is defined as the risk of fluctuations in the timing, frequency and severity of insured events relative to the expectations at the time of underwriting, and is inclusive of catastrophe risk within our internal model. Flood Re's most significant premium risk exposure is to losses arising from UK flood events, either from low frequency, high severity catastrophe events or from aggregation of more modest events.

The Company's most significant Premium Risk exposure is to losses arising from low frequency, high severity catastrophe flood events. Catastrophe loss events result in a high level of volatility in the financial results of the Company.

The major drivers behind the change in the year are as follows:

- **Levy 1** decreased by £45m from £180m to £135m (as part of the Major Model Change)
- **Net earned premium** increased by £2.6m following the update of gross and ceded premium estimates to reflect the volumes consistent for the latest forecast of the FY22-23 as well as the updated reinsurance programme.
- **Expenses** increased by £3.8m over the year in line with the latest estimates from the business plan forecast, this was driven by the increase in costs due to IFRS17 and managed service migration projects.
- **Net retained claims at the 1 in 200:** The underlying exposure over the year has increased resulting in a £287.6m increase in the gross 1 in 200 claims. The new structure and lower Agg XL retention of the Year 7-9 reinsurance programme (as part of the Major Model Change) has led to an increase in the modelled recoveries by £310.6m. This results in a decrease in the net claims of £23.0m;
- **Commission Clawback effect:** This has reduced by £7.3m over the year due to the new reinsurance structure and as the loss experience has increased it reduces the potential for commission clawback at the 1 in 200 level.

Premium thresholds represent the maximum that Flood Re can charge to insurers for flood cover. The premium thresholds, which can be adjusted annually for the percentage increase or decrease in the Consumer Price Index in the prior calendar year, are 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.

A decision was taken by the Company in 2018 not to pass on the effect of CPI indexation for 2019 to insurers. In addition, from 1 January 2019, Flood Re Limited reduced premium levels for building (12.5% reduction), contents (33% reduction) and combined (aggregate reduction) policies for all council tax bands, with the exception of the highest, in order to further facilitate affordable cover for those most at risk of flooding. No inflationary or other changes have been made to the premiums charged to insurers since.

The Company expects that assumed premium will not be sufficient to cover the estimated mean cost of claims. The cost of the subsidy provided through the premium thresholds is met by a Levy raised from all insurers writing Home Insurance in the UK. The Levy was set at £180m per annum, and will be £135m per annum from 1 April 2022.

**Reserve Risk**

As at 31 March 2022, the undiversified non–life Reserve Risk capital charge on a partial internal model basis is £8.1 m. (2021: £13.0m).

Reserve Risk is defined as the risk of loss or of adverse change in the value of insurance liabilities due to inadequate reserve assumptions. This is influenced by the frequency of claims, the severity of claims, the timing of actual claims payments and the development of the claims over a period of time.

The major drivers behind the change in the year are as follows:

- A £19.3m decrease in net best estimate claims reserves over the year. This is due to the historical catastrophe events becoming more mature;
- The attritional CoV reduced from 25.0% to 12.3%, due the attritional experience being relatively benign across the year.

**Lapse Risk**

As at 31 March 2022, the undiversified non–life Lapse Risk capital charge is £nil (2021: £nil).

Lapse Risk is defined as the risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level or volatility of the rates of policy lapses, terminations, renewals and surrenders. Lapse rates have been historically low and, as business written by Flood Re is written at a discount to the expected cost of claims, policy lapse rates do not present a material risk.

**Underwriting Risk mitigation**

The Company purchases reinsurance as a key element of its overall risk mitigation programme. Outwards Reinsurance is placed on both a proportional and non-proportional basis and is the Company's primary mechanism for managing and mitigating Insurance Risk.

The Flood Re Scheme Document establishes the requirement for the Company to set an annual aggregate loss amount or the Liability Limit. The amount of the Liability Limit is adjusted annually for the percentage increase or decrease in the Consumer Price Index in the prior calendar year.

Subject to these adjustments and a process of ongoing confirmation of appropriateness, the Liability Limit is set for a period of five years. Should claims exceed the Liability Limit, primary insurers will continue to be liable to policyholders in accordance with the terms of the insurance policy sold. However, Flood Re will only be liable to insurers up to the Liability Limit.

Flood Re requires that the outwards reinsurance protections purchased match the full Liability Limit. Furthermore, HM Government requires that Flood Re protect itself from an annual accounting loss above £100m in any one accounting period. To provide for both of these requirements Flood Re has purchased an extensive reinsurance programme.

The reinsurance programme is reviewed and approved by the Board in line with the business strategy and risk appetite. The Company uses both its own and commercially available proprietary risk management tools and models to assess catastrophe exposure.

Quarterly aggregate exposure monitoring involving catastrophe analysis by Guy Carpenter and review by the Actuarial Function, combined with quarterly reserve reviews are used to monitor the ongoing appropriateness of the reinsurance programme and the sufficiency of the reserves, premium and Levy income, as well as the Liability Limit.

## C.2 Market risk

**Prudent Person Principle**

The Company adheres to the Prudent Person Principle through the application of a conservative Market Risk strategy that prioritises capital preservation over investment return. The investment mandate agreed between the Company, Government and the Insurance Industry restricts the type, duration and amount of holdings that may be invested in. Flood Re only invests in UK Government backed securities (gilts, treasury notes and UK Government backed liquidity funds). Through its status as a Public Body, Flood Re has access to the UK Debt Management Office ("DMO") for investment purposes. Short-term deposits with the DMO vary for periods between one day and three months, depending on the immediate cash requirements of the Company.

**Interest Rate Risk**

As at 31 March 2022, the undiversified Interest Rate Risk capital charge, calculated on a Standard Formula basis, is £0.8 m (2021: £0.1m). The lowering of yield curves had caused Market Risk to increase by £0.8m and the inclusion of UK Treasury Gilts in the asset portfolio offset this by £0.05m.

Interest Rate Risk is the risk that the fair market value or future cash flows of a financial instrument will fluctuate because of changes in interest rates. An increase in interest rates will result in a decrease in the market value of debt securities and vice versa.

Given the short tail nature of Flood Re's assets and liabilities, the mismatch between asset and liability cash flows is limited and Interest Rate Risk is of low materiality. In particular the majority of the invested assets are currently held as cash or as short-term deposits with the DMO, so are considered risk free and not subject to Interest Rate Risk. Therefore, the Standard Formula approach is deemed proportionate and appropriate for this risk.

The impact of the change in the Market Risk is not material to the SCR.

**Market Concentration Risk**

As at 31 March 2022, the undiversified Market Concentration Risk capital charge is £nil (2021: £nil).

Concentration Risk is the risk of a financial loss arising from a lack of diversification in the investment portfolio or from a large exposure to any single issuer or sector.

The Company has a risk appetite for, and accepts Market Risk concentration arising from, exposure to the UK Government and from exposure to the financial services sector.

As at 31 March 2022, the Company has £663.7m (2021: £593.5m) of short-term deposits invested with the DMO representing 97% (2021: 100%) of the total invested assets. In addition, the Company has £17.9m in UK Treasury Gilts (2021: £nil).

**Equity Risk, Property Risk, Corporate Credit Spread Risk and Foreign Currency Risk.**

As at 31 March 2022, the undiversified risk capital charge is £nil (2021: £nil).

The company does not have any risk appetite or exposure to Equity Risk, Property Risk, Corporate Credit Spread Risk or Foreign Currency Risk. All transactions (other than a small number of expenses) are settled in pounds sterling.

*Market Risk mitigation*

Flood Re's investment strategy is conservative with a focus on preservation of capital. The investment portfolio is managed in accordance with the Board-approved risk appetite statements.

Flood Re's key liabilities derive from short tail, natural flood catastrophe events. It is anticipated that most claims will settle within one year of the date of loss. The Company ensures appropriate consideration of asset and liability duration matching to ensure policyholder protection.

Given the short tail nature of Flood Re's assets and liabilities coupled with the asset and liability matching policy, the mismatch between assets and liabilities cash flows is limited and Interest Rate Risk is of low materiality.

## C.3 Credit risk

As at 31 March 2022, the undiversified Credit Counterparty Risk capital charge on a partial internal model basis is £7.7m (2021: £8.4m).

Counterparty credit risk is defined as the risk of not recovering amounts owed to Flood Re by third parties. The Company's maximum exposure to credit risk is the gross carrying value of its levy receivables, reinsurance premium receivables, reinsurance recoveries, trade and other receivables and cash and short-term deposits.

The change in the undiversified capital charge is driven by the £2.6m decrease in Reinsurance Credit Risk. This reduction is due to an update in the reinsurer counterparty panel as a result of the new outwards reinsurance programme, with the majority of reinsurers now being AA- rated (previously rated A+ or below).

***Credit Risk mitigation***

The Company uses issuer credit ratings provided by external credit rating agencies to monitor the ongoing creditworthiness of its counterparties, together with other publicly-available data and market information.

Ceded reinsurance arrangements do not relieve the Company from its obligations to policyholders. Reinsurance is only placed with counterparties that have a minimum credit rating of A- (S&P equivalent). No single reinsurer can exceed the maximum credit counterparty exposure thresholds established by the Company's Board.

Cedants submit premium bordereaux on a monthly basis and settlement is due 30 days thereafter. Levy income has a statutory basis and is due quarterly in advance. The level of aged debtor balances is monitored on a monthly basis.

## C.4 Liquidity risk

As at 31 March 2022, the Liquidity Risk capital charge is £nil (2021: £nil).

The Company defines liquidity risk as the risk of not being able to meet current and future financial obligations as and when they fall due, or only being able to do so at excessive cost. The Company must maintain sufficient liquidity at all times to support its cedants by settling claims quickly. The Company generates cash inflows primarily from Levy I, premium and investment income and is exposed to significant cash outflows arising from reinsurance claims costs and operating expenses.

The Company monitors its liquidity and future cash flow requirements on a regular basis and maintains a high quality, well-balanced and liquid investment portfolio. There is uncertainty around the timing and severity of claims costs. The maturity profile of the Company's invested assets is aligned to the short-term nature of the business underwritten, whereby insurance contract liabilities are generally incurred and settled within one year. For the period ending 31 March 2023, the Company anticipates generating positive cash flows, unless there is a series of large flood events.

As at 31 March 2022, the Company has invested and liquid assets of £690.8m (2021: £610.7m), representing 88% (2021: 85%) of its total equity and liabilities and 987% (2021: 1,557%) of the Solvency Capital Requirement (SCR). Invested and liquid assets comprise amounts included in the investments in debt instruments, cash and short-term deposits.

The Company expects that assumed premium will not be sufficient to cover the estimated mean cost of claims. A gross premium deficiency provision of £28.9m (2021: £17.7m) has been established to recognise the overall excess of expected claims over unearned premium. As at 31 March 2022, the Expected Profit Included in Future Premium (EPIFP) is £nil (2021: £nil).

## C.5 Operational risk

As at 31 March 2022, the Operational Risk capital charge calculated on a partial internal model basis is £25.0m. (2021: £25.0m).

Operational Risk is defined as the risk of loss arising from inadequate or failed internal processes, personnel or systems, or from external events.

When controls fail to perform, Operational Risks can cause damage to reputation, have legal or regulatory implications or can lead to financial loss. Flood Re manages Operational Risks to minimise financial losses, and risks to its reputation and industry standing.

The Flood Re risk register has identified a number of Operational Risks split into four risk levels (Top, High, Medium and Low). The Operational Risks classified into the top and high risk category include failure in outsourcing, ineligible claims and information security risks.

Whilst there has been some assessed increase to areas of Operational Risk during the year, in particular changes in the Key Person Risk across the year due to changes in personnel, these changes were not assessed as having a material impact on the very extreme scenarios that drive Operational Risk at the 1 in 200 level.

***Operational Risk mitigation***

The Company's operating model makes significant use of outsourced service providers (see Section B.7) to deliver a number of key operational elements. The relationship with, and management of, the outsourced service providers is a key component of the Operational Risk profile.

The Company's operational policies and procedures set out how various Operational Risks are managed throughout the Company. See section B.4 for a discussion of risk mitigating factors arising from the operation of the Internal Control system.

## C.6 Other material risks

### C.6.1 Strategic Risk

Strategic Risk is defined as the risk of non-achievement of the Company's strategic objectives due to the failed implementation of strategic plans, a flawed strategic plan or changed external environment.

*Risk mitigation*

The CEO is responsible for the execution of the overall business strategy. The business strategy and operational plans are reviewed and approved by the Board on at least an annual basis. Performance against plan is monitored on an ongoing basis. The Board includes Independent Non-Executive Directors with Parliamentary experience and background to engage with political stakeholders. The Company has an extensive ongoing engagement process with the insurance industry and DEFRA.

The Company has a statutory duty to publish a transition plan, updated on a regular basis which sets out how the market will return to risk-reflective pricing. The first transition plan was published in February 2016, with an update, "The Flood Re Transition Vision" published in July 2018. The next Transition Plan is scheduled to be published in 2023 and will set out Flood Re's progress to and plans for its 2039 exit.

### C.6.2 Sensitivity, Stress and scenario testing

Sensitivity, Stress and Scenario Tests are key risk management tools that allow the Company to assess the consequences of future events and determine whether risk-mitigating actions should be taken to manage their associated impacts.

**Sensitivity and Stress Tests** – Simple shocks focused on changing one key variable or parameter (e.g. expected volumes, loss ratios, investment income, operational expenses) to assess the impact on the Company's financial strength.

**Scenario Tests** – More complex sequences of shocks that can be based on historic events or created to assess the impacts of potential events that have not yet occurred.

**Reverse stress tests** – Stress tests that require Flood Re to assess scenarios and circumstances that would render its business model unviable. Flood Re's reverse stress tests seek to consider both the key threats to its operation as a reinsurance entity as well as medium- and longer-term threats to its Transition Objectives.

It is essential that Flood Re's Board, Committees and management are able to understand the effect of changing market and business conditions on Flood Re's business plan, risk profile, solvency and liquidity. This will ensure they are able to proactively manage risks and the Company's capital position.

Flood Re has broadly split Sensitivity, Stress and Scenario Testing into the following areas and uses:

***Sensitivity, Stress & Scenario Testing of the Business / Strategic Plans (Business Planning and ORSA Stress and Scenario Tests)***

- The assumptions underpinning the business plan and financial forecasts, are subject to a range of sensitivity, stress and scenario testing to determine the robustness of the business model and to identify potential management actions following a major event.

*Model Validation*

- Sensitivity, Stress and Scenario Testing can provide an alternative quantitative lens through which to assess specific risks to Flood Re and compare these against equivalent partial internal model outputs.
- The Company undertakes internal model validation exercises and delivers a suite of Sensitivity and Stress Tests (across each of its risk areas), focused in particular on assessing the most material assumptions and expert judgements within the Internal Model.

*Model Calibration*

- Flood Re uses a scenario-based approach to model Operational Risk in the Internal Model. Operational Risk workshops assist in the identification of the scenarios and facilitate risk quantification.

*Reverse Stress Testing (RST)*

- Annual RSTs seek to identify and assess events and scenarios that could lead to the business model becoming unviable and consider key points of strategic dependencies and consequences of severe reputational damage.

*Risks not captured in the PIM*

- Flood Re uses targeted stress/scenario tests to assess risks not explicitly captured within the Internal Model.

*Regulatory Sensitivity, Stress and Scenario Testing*

- The Company performs Sensitivity, Stress and Scenario testing in response to annual industry stress testing exercises requested by the UK Regulator (PRA). Flood Re will be completing relevant scenarios in the upcoming 2022 General Insurance Stress Testing Exercise led by the PRA.

*Emerging Risk Sensitivity, Stress and Scenario Testing*

- Emerging Risks (e.g. Climate Change) are subject to Sensitivity, Stress and Scenario Testing on an ad-hoc basis to assess the impact and identify the appropriate management actions to control or mitigate the risks.

### C.6.3 Sensitivity, Stress and scenario outcomes

Flood Re's solvency position has continued to strengthen this year, further reinforcing the conclusions of high financial and solvency strength from the testing performed at the last two year ends for the ORSA. Consequently, our focus in this year's ORSA has been on increasingly using stress and scenario testing to assess wider scheme parameters, limits and longer-range strategic challenges. This has taken the form of the following:

1) **Short Term (1–3 Years): Using SST's to set our Solvency Risk Appetite Thresholds**: SST's have been used to set the Operational Capital Requirement (early warning indicator for solvency erosion) to manage the quarterly cyclical nature of Flood Re's PIM SCR

2) **Medium Term (3-5 Years) – Stressing the Flood Re Loss Limit (Reverse Stress Testing)**: Targeting a breach of the £100m loss limit to assess if there are any scenarios over the medium term which could aggregate to deliver an annual loss which breached this Scheme limit.

3) **Long Term (through to 2039 Exit) – Using 2021/22 Regulatory Climate Change scenarios**: Leveraging the results and responses to the Bank of England's Climate Biennial Exploratory Scenarios (CBES) to feed into Flood Re's Transition and Exit Planning.

Wider stress and scenario testing has also been completed this year to support model testing and validation, setting the liability limit and for reviewing the structure of the new three-year reinsurance programme. The major next step in Scenario Testing planned for 2022/23 will be the delivery of Operational Resilience Scenarios to test the resilience and recoverability of Flood Re's Important Business Service.

## C.7 Any other information

Flood Re has experienced limited direct financial exposure to the impacts of COVID-19. This is due to the Company's single peril risk exposure, conservative investment portfolio and the secure level of capitalisation.

The majority of the first order implications of COVID-19 have diminished over the course of 2021/22, particularly by year end, with other risks drivers (e.g., current heightened inflationary environment) taking precedence for risk management oversight and action. In terms of Flood Re's operating model, in the latter half of 2021/22 we have moved from a fully remote working environment in response to COVID-19 lockdowns to a Hybrid Working Model which seeks to draw on the benefits of both flexible home working and in office cross-team collaboration.

# D. Valuation for Solvency Purposes

The statutory financial statements of Flood Re Limited are prepared in accordance with IFRS. For Solvency II valuation purposes, assets and liabilities are valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction (Article 75 the Solvency II and Insurance (Amendment, etc.) (EU Exit) Regulations 2019).

The table below shows a reconciliation between excess assets and liabilities valued on an IFRS GAAP basis and a Solvency II basis as at 31 March 2022.

| | | IFRS | SII | Difference |
|---|---|---|---|---|
| | | £000s | £000s | £000s |
| **Assets** | | | | |
| Property, Plant & Equipment | D.1a | 2,984 | - | (2,984) |
| Investments | | 17,916 | 18,212 | 296 |
| Cash and short-term deposits | D.1b | 672,946 | 672,946 | - |
| Reinsurers' share of unearned premium | D.2a | 28,518 | 1,680 | (26,838) |
| Recoveries due on paid losses | D.1c | - | - | - |
| Claims provision recoverable | D.2d | 49,502 | 35,766 | (13,736) |
| Insurance and intermediaries receivables | D.1c | 7,087 | - | (7,087) |
| Reinsurance receivables | D.1c | 9,404 | - | (9,404) |
| Receivables (trade, not insurance) | | 927 | 2,332 | 1,405 |
| **Total Assets** | | **789,284** | **730,936** | **(58,348)** |
| | | | | |
| **Liabilities** | | | | |
| Unearned premium | D.2a | 24,421 | - | (24,421) |
| Loss reserves | D.2b | 97,019 | - | (97,019) |
| Best estimate claims provision | D.2b | - | 75,609 | 75,609 |
| Best estimate premium provision | D.2b | - | 37,093 | 37,094 |
| Risk margin | D.2c | 6,831 | 5,509 | (1,323) |
| Insurance and intermediaries payables | D.3a | 7,773 | 3,589 | (4,184) |
| Reinsurance payables | D.3a | 36,852 | - | (36,852) |
| Payables (trade, not insurance) | D.3b | 27,914 | 27,914 | - |
| **Total Liabilities** | | **200,810** | **149,714** | **51,096** |
| | | | | |
| **Excess assets over liabilities** | | **588,474** | **581,222** | **(7,252)** |
| | | | | |
| **Analysis of movement** | | | | |
| Decrease in other assets | D.1 | | | (17,775) |
| Decrease in net technical provisions | D.2 | | | 1,983 |
| Decrease in other liabilities | D.3 | | | 8,540 |
| **Total** | | | | **(7,252)** |

Flood Re is engaged in the provision of reinsurance cover for a single risk (property), a single peril (flood), single currency (pounds sterling) within a single territory (United Kingdom).

Under Solvency II, all underwriting transactions are classified and recorded under the Proportional Reinsurance – Fire and other damage to property line of business.

The bases, key methods and main assumptions for all assets and liabilities on both the IFRS and SII bases have been in place throughout the year and are not materially different at 31 March 2021 to those used at 31 March 2022.

See section C for the impact of the PIM in assessing the risk components of the SCR, as implemented from 1 April 2020 and as amended at 31 March 2022, and section E.3 Differences between the standard formula and the Internal Model used.

## D.1 Assets

The material differences between the bases, methods and main assumptions used to value assets for solvency purposes compared to the IFRS statutory financial statements are outlined below:

**a. Gilts**

Short term investment holdings predominately comprise of UK gilts as part of the wider investment portfolio that were purchased during the Q3 of the current financial period. The UK Gilts were purchased in the period alongside holdings with the DMO.

For Solvency II valuation purposes, short-term investments are valued in conformity with IFRS and are measured at fair value through other comprehensive income ("FVOCI").

**b. Property Plant Equipment**

Property, plant and equipment comprise leased buildings, leased IT infrastructure and IT hardware. Leased Buildings and IT infrastructure is stated at present value of future lease payments and IT hardware is stated at depreciated cost for IFRS reporting.

For Solvency II valuation purposes, these assets are valued at nil.

**c. Cash and short-term deposits**

Cash and short-term deposits comprise cash at banks and on hand and short-term deposits with a maturity of three months or less, which are subject to an insignificant risk of changes in value.

For Solvency II valuation purposes, cash and short-term deposits are valued in conformity with IFRS and are inclusive of accrued interest. As highlighted in the previous section, Flood Re's investment management approach focuses on capital preservation and Liquidity Risk management over investment return, hence the material level of Flood Re's invested assets held in cash and short-term deposits.

**d. Insurance and reinsurance receivables**

Reinsurance receivables consist primarily of assumed reinsurance premiums due from policyholders and commission income due from reinsurers.

For Solvency II valuation purposes, reinsurance and commission receivables are valued in conformity with IFRS. Amounts due but not yet received are included in the SII balance sheet as receivables. Amounts not yet due are included in the cash flows used to calculate Technical Provisions (see D2).

## D.2 Technical Provisions

The material differences between the bases, methods and main assumptions used to value Technical Provisions for solvency purposes compared to the IFRS statutory financial statements are outlined below. All items are shown net of reinsurance:

| | **2022 £000** | | **2021 £000** |
|---|---|---|---|
| Unearned premium | 12,759 | | 10,151 |
| Insurance claims liabilities | (37,591) | | (59,121) |
| **IFRS technical provisions** | **(24,832)** | | **(48,970)** |
| | | | |
| Less: Unearned premium | (12,759) | | (10,151) |
| Less: Reserve margins and premium deficiency | 3,450 | | 7,481 |
| Add: Future claims liabilities | (21,420) | | (15,418) |
| Add: Future claims expenses | (3,140) | | (2,726) |
| Reclassify: receivables/payable not yet due | 923 | | (151) |
| Add: Future premium and commission cash flows | (18,030) | | (25,653) |
| Add: Risk margin | (5,509) | | (4,968) |
| Less: Allowance for reinsurer default | (99) | | (50) |
| Discounting | 651 | | (48) |
| **Total adjustments** | **(55,933)** | | **(51,684)** |
| | | | |
| **Total SII Technical Provisions** | **(80,765)** | | **(100,654)** |
| | | | |
| Best estimate claims provision | (39,843) | | (56,247) |
| Best estimate premium provision | (35,413) | | (39,440) |
| Risk Margin | (5,509) | | (4,968) |
| **Total** | **(80,765)** | | **(100,654)** |

*a. Unearned premium*

Solvency II dispenses with the concept of unearned premium and instead requires reinsurers to hold reserves based upon best estimate cash flows (premiums, claims and expenses) in respect of the unearned element of all business written or legally obligated to be written at the valuation date.

*b. Best estimate provisions*

Solvency II Technical Provisions are calculated applying a probability-weighted average of future cash flows, taking account of the time value of money using the relevant risk-free interest rate term structure. Exposure relating to legal obligations is included.

IFRS premium deficiency provisions and loss reserve margins are excluded from the best estimate under Solvency II.

The cash flow in respect of the component of the technical provisions related to the earned element is termed “claim provisions” and the unearned element is termed “premium provisions” and includes reinsurance receivable and payable cash flows not yet due (see section D.1 and D.3).

The Solvency II best estimate includes cash flows from expenses incurred servicing existing policies during their lifetime and are allocated between premium and claim provisions.

All future cash flows are discounted using market consistent risk-free rates of interest.

Future cash flows are adjusted to allow for expected default, whether from insolvency, dispute or other reason. This requires a consideration of the probability of default and the average loss following default over the whole run-off period. This approach is applied to premium and claims provisions.

*c. Risk margin*

An explicit risk margin is added to Technical Provisions. The risk margin is based on a market consistent cost of capital approach of transferring the liabilities to a third party. The current cost of capital rate is 6%, with the future solvency capital requirement now based on the Internal Model.

*d. Provisions recoverable*

Technical Provisions are calculated applying a probability-weighted average of future cash-flows, taking account of the time value of money using the relevant risk-free interest rate term structure and based on the reinsurance programme in place. Cash flows include reinsurance receivables and payables not yet due (see section D.1 and D.3).

*e. Events not in data (ENID)*

In order to establish the best estimate Solvency II Technical Provisions a full distribution of outcomes is considered, thereby including a provision for ENIDs within both claim and premium provisions.

**Material cash flow assumptions used in the calculation of Technical Provisions**

*Lines of business*

The Company provides reinsurance protection for a single risk (property damage) and a single peril (Flood) within the United Kingdom. All transactions are in Pounds Sterling.

*Premiums*

Insurance companies select the policies they wish to cede to Flood Re and report these via the submission of a monthly bordereaux. Settlement is due 30 days after submission. Insurance companies have up to 120 days from the inception date of the policy to notify Flood Re.

*Claims*

Flood Re is only required to pay a claim when the underlying claim has been settled by the direct insurer. Insurance companies submit claims bordereaux on a monthly basis. Flood Re has up to one month to pay a claim from receipt of the claims bordereaux. Claims normally settle within one year from the date of loss, and hence Flood Re's Investment Policy sets out an Asset Liability Management approach which aligns to this Interest Rate Risk profile (short term, low risk investments). The maximum loss payable by Flood Re is limited to the sum insured less a £250 policy deductible, or end consumer policy deductible, if larger.

*Levy I Income*

Levy I Income is payable quarterly in advance commencing on 1 April of each year. The Levy is not considered to be insurance income. However, as the cost of the subsidy provided through the Premium Thresholds is met through the £180m annual market Levy, the outwards reinsurance pricing references the Levy I income for the purposes of calculating an estimated fair risk premium.

*Ceded reinsurance*

For Excess of Loss contracts, a minimum and deposit premium is payable quarterly in arrears with a final adjustment premium due 120 days after the contract end date.

For Quota Share contracts, Flood Re is required to prepare a bordereaux 60 days after the quarter end with settlement due 30 days thereafter. The Company receives a sliding scale profit commission. Commission income is received via net settlement in the quarterly bordereaux.

*Reinsurance recoveries*

Amounts recoverable from reinsurers are estimated in a manner consistent with the outstanding claims provision and are in accordance with the reinsurance contracts.

The Company does not have any reinsurance contracts with or recoveries due from Special Purpose Vehicles.

*Changes in assumptions*

The above cash flow assumptions have been in place throughout the years ended 31 March 2022 and 2021. They are reviewed on at least a quarterly basis.

**Assumptions and uncertainty**

The principal assumption underlying the liability estimates is that the Company's future claims development will follow a similar pattern to past claims development experience. This includes assumptions in respect of average claim costs for different kind of events, claim handling costs, claim inflation factors (adjusted for COVID-19 considerations) and claim numbers for each accident year. The Company only commenced underwriting in April 2016 and is therefore partly reliant on historical industry claims data rather than the Company's specific claims data.

Qualitative judgements are used to assess the extent to which past trends may not apply in the future. There will be uncertainty around:

- The number of flood-affected properties ceded to the Company

- The portfolio mix of business impacting average premium and average claims cost assumptions
- Split of business by Council Tax band
- Type of policy (covering buildings only, contents only or combined cover)
- Variability in the actual claims pay-out patterns
- Delays in notification of claims to the Company
- Assessment of the level of claims costs, including aspects such as additional living expenses
- Recoverability of amounts due under the outwards reinsurance programme.

The Company monitors flood risk exposure on a per risk and on an aggregate sum insured basis and performs exposure modelling on at least a quarterly basis or on the occurrence of an event.

Given the relatively high cost of flood claims compared with the size of typical Household Insurance claims, most flood claims will have been assessed by a loss adjuster before being notified to Flood Re. Furthermore, strict claim review policies to assess new and ongoing claims, regular detailed review of claims handling procedures and frequent investigation of possible fraudulent claims are established to reduce the risk exposure of the Company. The Company enforces a policy of actively managing and promptly pursuing claims, in order to reduce its exposure to unpredictable future developments that can negatively impact the Company.

In setting claims provisions, the Company considers the probability and magnitude of future experience being more adverse than assumed and exercises a degree of caution in setting reserves where there is considerable uncertainty. In general, the uncertainty associated with the ultimate claims experience in an accident year is greatest when the accident year is at an early stage of development and the margin necessary to provide the necessary confidence in the provision's adequacy is relatively at its highest. As claims develop, and the ultimate cost of claims becomes more certain, the relative level of margin maintained should decrease. However, due to the uncertainty inherent in the estimation process, the actual overall claim provision may not always be in surplus.

The Company estimates cash flow payment patterns for premium, claims and recoveries based on data gathered from a range of sources (e.g., cedants, reinsurers and the Association of British Insurers).

The pipeline premium assessment will be informed by the latest reforecast plan.

Flood Re pays its claims only once the underlying claim has settled and therefore has a longer claims payment pattern compared to cedants. There is uncertainty as to the extent to which cedants might accelerate claim settlements in order to trigger a payment from Flood Re. Payment patterns may vary between attritional and flood event losses and between different flood events.

**Management actions**

For the purposes of calculating the Solvency II best estimate and risk margin, Flood Re only recognises obligations within the boundary of the assumed or ceded reinsurance contracts.

Flood Re is able to cancel Inwards Reinsurance Treaties with 30 days' notice. Underlying policies that are incepted before the termination date, assumed to be one-month worth of policies, need to be taken into account as obligated contracts at any balance sheet date.

All outwards reinsurance contracts include a clause giving Flood Re the option to either continue or terminate the contract. The Company is required to provide one month's advance notice if it wishes to terminate its outwards reinsurance contracts mid-term in the event of ceasing trading.

The assumed management action would be to terminate the contracts and invoke the notice period.

A further management action aims to protect the remaining exposure over the run-off period through the purchase of equivalent outwards reinsurance. These revised cash flows are included on an estimated pro rata cost basis.

## D.3 Other liabilities

The material differences between the bases, methods and main assumptions used to value other liabilities for solvency purposes compared to the IFRS statutory financial statements are outlined below:

**a. Insurance and Reinsurance payables**

Reinsurance payables consist primarily of claims payable to insurers, premiums payable for ceded reinsurance contracts and deferred commission income.

For Solvency II valuation purposes, claims and premiums payable are valued in conformity with IFRS. Amounts due but not yet paid are included in the Solvency II balance sheet as payables. Amounts not yet payable are included in the cash flows used to calculate technical provisions (see D2).

For Solvency II valuation purposes, deferred commission income is non-admitted. Future commission income cash flows are included in the calculation of the Solvency II Technical Provisions (see D2).

**b. Trade and other payables**

Trade and other payables consist primarily of Levy I receipts in advance, corporation tax liability, accrued expenses and staff costs.

For Solvency II valuation purposes, Levy I receipts in advance, accrued expenses and staff costs are valued in conformity with IFRS. Current and deferred IFRS tax assets and liabilities are adjusted by applying a corporation tax rate of 19% (2021: 19%) to the SII asset and liability valuation adjustments.

**Timing and uncertainty**

For Insurance and Reinsurance payables and Levy I receipts see section D.2 above. Current income tax assets and liabilities are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted, or substantively enacted, by the reporting date. Current income tax assets and liabilities also include adjustments for tax expected to be payable or recoverable in respect of previous periods.

**Contractual commitments excluding operating leases**

| | 2022 | 2021 |
|---|---|---|
| | £000 | £000 |
| Service contracts | 1,941 | 5,126 |
| Staff contractual commitments | 2,416 | 2,057 |
| Other financial commitments | 628 | 569 |
| **Total commitments** | **4,985** | **7,752** |
| | | |
| Due within one year | 4,985 | 7,752 |
| Due later than one year but not later than five years | - | - |
| **Total commitments** | **4,985** | **7,752** |

All other contractual commitments have cancellation clauses of one year or less.

## D.4 Alternative methods for valuation

Not applicable.

## D.5 Any other information

**COVID-19 Financial Assessment**

For historic Event reserves we allow for a COVID uplift. We assume that normal levels of inflation are implicit in the case reserves set which inform our average cost per claim assumption for events. We apply this fixed percentage uplift (last revised at Q2 2022) as we believe the case reserves will not have adequately allowed for the increased inflation in months affected by both Covid and Brexit given the uncertainty these two events presented.

**Matching adjustment**

The Company does not make use of any matching adjustment (Article 77b), volatility adjustment (Article 77d), transitional risk-free interest rate term structures (Article 308b) or transitional deductions (Article 308d) referred to in the Solvency II and Insurance (Amendment, etc.) (EU Exit) Regulations 2019.

# E. Capital Management

## E.1 Own Funds

**Capital objectives**

The principal objectives of the Flood Re capital management framework are:

- Preservation of capital to ensure the long-term financial stability of the Company
- Policyholder protection through maintenance of capital margins in excess of regulatory capital requirements
- Maintenance of an appropriate Standard and Poor's financial strength credit rating of A (stable).

**Capital Modelling**

The Company models its economic capital requirements over a five-year business-planning horizon utilising risk and economic capital modelling software to produce an Internal Model. The Internal Model, in addition to assessing the SCR, informs decision making around the optimisation of the reinsurance strategy, premium threshold levels, Levy I income, the Levy II mechanism, the Liability Limit and risk appetite statements and financial business planning. In addition, the model forms a key part of the QQR-related decision-making process.

Capital management balances the need to build up adequate reserves, largely through the annual Levy process, against the overall cost to the industry of funding the Scheme.
Flood Re's objective is to enable the continued availability of affordable flood cover for households at risk of flooding and manage a transition to a market with risk-reflective pricing over a 25-year period. The Company published its first transition plan in February 2016, with an update, "The Flood Re Transition Vision" published in July 2018.

**Sources of capital**

Flood Re is a Company limited by guarantee and has no issued share capital. For the purpose of the Company's capital management, capital includes

- Retained profits (Tier I basic own funds);
- Mutual members accounts (Tier 1 restricted basic own funds);
- Uncalled Levy II income (Tier 2 ancillary own funds); and
- Deferred tax assets (Tier 3 basic own funds)

Flood Re charges cedants subsidised fixed-rate premiums. To meet the costs of this subsidy, Levy I income is raised from all insurers writing Home Insurance in the United Kingdom. The Levy has a statutory basis and provides the Company with a guaranteed income stream. This income stream allows the Company to protect its capital base by purchasing reinsurance protection and to build up a surplus of funds during low loss occurrence years so that it can withstand large catastrophic loss events.

**Uncalled Levy II income - Ancillary own funds**

Flood Re has the ability to issue a compulsory call for additional funding from the industry through a Levy II top up mechanism.

- Levy II contributions received from the Ordinary Members of Flood Re are recognised in a mutual member account ("MMA") within equity.
- Levy II contributions received from non-members are treated as income in accordance with Levy I.

Both methods result in an increase in Tier 1 basic own funds.

Ordinary Members of Flood Re are potentially eligible for their Levy II contributions to be returned, subject to Board and Prudential Regulation Authority approval.

The PRA has re-approved Flood Re to use 50% of the SCR, capped at a monetary amount of £75m, as a method by which uncalled Levy II may be recognised as an ancillary own-fund item for the period 1 April 2022 to 31 March 2027 (prior approval was effective for the period from 29 March 2019 to 31 March 2022). The minimum frequency of recalculation of the amount of ancillary own funds item using this method is every three months.

**Capital Adequacy**

The table below shows the Company's available capital for the year ending 31 March 2022 and 2021.

The Company has complied at all times with the regulatory Minimum Capital Requirements and the Solvency Capital Requirements.

| **Solvency Capital Ratios** | | **2022 £000** | | **2021 £000** | | **Change £000** |
|---|---|---|---|---|---|---|
| Basic Own Funds (Tier 1 Unrestricted) | A | 579,521 | | 471,077 | | 108,444 |
| Deferred tax assets (Tier 3) | | 1,701 | | 2,006 | | (305) |
| **Total basic own funds** | | **581,222** | | **473,083** | | 108,139 |
| Ancillary own funds (Tier 2) – 50% of SCR | B | 34,105 | | 19,606 | | 14,499 |
| **Available own funds** | C | **615,327** | | **492,689** | | 122,638 |
| **Eligible own funds to support SCR** | A+B | **613,626** | | **490,683** | | 122,943 |
| **Eligible own funds to support MCR** | **A** | | | 471,077 | | (471,077) |
| Solvency Capital Requirement (SCR) | E | 68,210 | | 39,211 | | 28,999 |
| Minimum Capital Requirement (MCR) | F | 17,052 | | 9,803 | | 7,249 |
| Ratio of eligible own funds to meet the SCR | (A+B)/E | 900% | | 1,251% | | (351)% |
| Ratio of basic own funds to meet the MCR | A/F | 3,398% | | 4,805% | | (1,407)% |

| **Reconciliation of equity to available own funds** | | 2022<br>£000 | | 2021<br>£000 |
|---|---|---|---|---|
| Total equity on an IFRS basis | | **588,474** | | **481,634** |
| Adjustment in respect of: | | | | |
| Decrease in valuation of assets | D.1 | (17,775) | | (16,526) |
| Increase in valuation of technical provisions | D.2 | 1,983 | | (31,639) |
| Decrease in the valuation of other liabilities | D.3 | 8,540 | | 39,614 |
| Basic Own Funds | | **581,222** | | **473,083** |

| **Reconciliation reserve** | | 2022<br>£000 | | 2021<br>£000's |
|---|---|---|---|---|
| Basic Own Funds - Excess of assets over liabilities | | **581,222** | | **473,083** |
| Foreseeable dividends | | | | - |
| Other basic own fund items | | | | |
| Deferred tax assets | | (1,701) | | (2,006) |
| **Reconciliation reserve (Tier 1 Unrestricted)** | | **579,521** | | **471,077** |

The movement in available own funds is due to:

- Basic own funds: an IFRS after tax profit for the year ended 31 March 2022 of £106.9m (2021: £114.9m) (see section "A.2 Underwriting performance", "A.3 Investment performance" and "A.4 Performance of other activities" for a discussion of the items contributing to the increase in retained earnings), coupled with the movement between IFRS and Solvency II Technical Provisions (see D.2).
- Ancillary own funds: Calculated as 50% of the SCR (capped at a monetary amount of £75m), this increased by £14.5m due to the increase in the SCR in the year (see E.2).
- Deferred tax assets: The Solvency II deferred tax asset is calculated by applying the corporation tax rate to the valuation differences between Solvency II and IFRS. See section D for a discussion of the material differences between shareholders equity on an IFRS basis and excess of assets over liabilities on a Solvency II basis.

Tier 1 own funds consist of the reconciliation reserve (see section A.2 – A.4 for the potential volatility of the reconciliation reserve).

As at 31 March 2022 and 2021, there are no restrictions impacting on the availability and transferability of own funds. In March 2022, deferred tax assets of £1.7m have been deducted from own funds (2021: £2m).

No basic own fund items are subject to transitional arrangements.

See section D for a discussion of the material differences between shareholders equity on an IFRS basis and excess of assets over liabilities on a Solvency II basis.

**Operational capital**

Flood Re assess the Solvency Ratio using an Operational Capital Requirement as an early warning indicator to monitor its solvency risk appetite. This alternative measure reflects longer-term expectations for the SCR and smooths the SCR's cyclicality. This has been set at £100m over recent periods, however with the reduction in Levy 1 and the commencement of a new reinsurance programme from 1 April 2022, the Board has approved the updating of the measure to £130m for year end 31 March 2022. The CFO monitors the continuing appropriateness of the measure as the evolution of the risk profile of the Scheme changes.

**Eligibility and limits applicable to own funds**

The Company must ensure that it has enough capital of sufficient quality to meet the SCR and MCR eligibility requirements.

The Company must be able to meet at least 50% of its SCR with tier 1 own funds, of which only 20% can be restricted. A maximum of 15% of the SCR may be met by Tier 3 Capital. A maximum of 50% of the SCR may be met by Tier 2 and Tier 3 capital.

The Company's Minimum Capital Requirements must be met with a minimum of:

- 80% of basic Tier 1 own funds
- 20% of basic Tier 2 own funds

Ancillary Own Funds are not eligible to meet the MCR.

As at 31 March 2022 and 2021, 100% of the SCR and MCR requirements are met with unrestricted Tier 1 own funds.

**Dividend distributions**

The company can only distribute dividends from its Mutual Members' Account (MMA) which is derived from funds raised by means of Levy II. The company has not raised any Levy II contributions in its operations to date and hence the accumulated MMA at as at 31 March 2022 is £nil (2021: £nil) and there are no possible dividend distributions at this time.

In the event of raising Levy II funding, there is no requirement for the Company to redistribute, to its Ordinary Members, the accumulated surplus held in the MMA. The Company may repay mutual members balances that relate to previous Levy II calls from the industry provided that:

- The accumulated surplus capital is in excess of the SCR requirements
- A period of five years has elapsed since the original Levy II call was made, and
- The PRA approves the distribution to Ordinary Members.

## E.2 Solvency Capital Requirement and Minimum Capital Requirements

**Solvency Capital Requirement**

Flood Re's Solvency Capital Requirements is calculated using an approved Partial Internal Model. The Partial Internal Model was approved by the PRA for regulatory capital assessment purposes from 1st April 2020 onwards. Prior to that date Flood Re assessed its regulatory capital using the Standard Formula.

The table below shows the Solvency Capital Requirements from the Partial Internal Model as at 31 March 2022 and 31 March 2021. A comparison of the Partial Internal Model and Standard Formula results is shown in section E.3.

| SCR | 2022 | | 2021 | | Change |
|---|---|---|---|---|---|
| | £000 | | £000 | | £000 |
| Premium Risk | 34,497 | | 3,977 | | 30,520 |
| Reserve Risk | 8,070 | | 13,046 | | (4,976) |
| Diversification Benefit | (3,952) | | (9,005) | | 5,053 |
| **Insurance Risk** | **38,615** | | **8,018** | | **30,597** |
| RI Credit Risk | 4,701 | | 7,263 | | (2,561) |
| Other Credit Risk | 4,652 | | 4,544 | | 109 |
| Diversification Benefit | (1,615) | | (3,395) | | 1,780 |
| **Counterparty Default Risk** | **7,738** | | **8,412** | | **(673)** |
| Interest Rate Risk | 837 | | 51 | | 787 |
| **Market Risk** | **837** | | **51** | | **787** |
| **Operational Risk** | **24,968** | | **24,968** | | **-** |
| Undiversified SCR | 72,158 | | 41,447 | | 30,711 |
| Diversification benefit | (3,948) | | (2,236) | | (1,712) |
| **SCR** | **68,210** | | **39,211** | | **28,999** |

The Company does not use any undertaking specific parameters or simplified calculations when calculating its Solvency Capital Requirements using the Standard Formula.

**Movements in the SCR**

The changes in the SCR above are driven largely by changes in the risk profile of Flood Re over the year including:

- The major model change which includes a reduction in the levy from £180m to £135m and a change in the reinsurance structure
- Run off in the claims reserves held by Flood Re on its balance sheet

Flood Re have increased its underlying inflation assumption to reflect increases in CPI and Housing Rebuild indices over the year.

**Minimum Capital Requirement**

The table below shows the calculation of the Minimum Capital Requirement as at 31 March 2022 and 2021.

| Minimum Capital Requirement calculation | 2022<br>£000 | | 2021<br>£000 | | Change<br>£000 |
|---|---|---|---|---|---|
| Linear SCR | 7,415 | | 9,009 | | (1,594) |
| MCR Cap (45% of the SCR) | 30,694 | | 17,645 | | 13,049 |
| MCR Floor (25% of the SCR) | 17,052 | | 9,803 | | 7,249 |
| Combined MCR | 17,052 | | 9,803 | | 7,249 |
| Absolute floor of the MCR | 3,042 | | 3,247 | | (206) |
| **Minimum Capital Requirement** | **17,052** | | **9,803** | | **7,249** |

The linear SCR is calculated by applying an EIOPA prescribed, UK adopted, line of business loading of 9.4% to the net of reinsurance best estimate and Technical Provision value of £78.9m (2021: £95.8m).

The Combined MCR is the minimum of the MCR Cap compared to the maximum of the Linear SCR and the MCR Floor.

The absolute floor is €3.6m converted at a closing rate of €1/£0.8449 (2021: €1/£0.90208).

**Analysis of changes in the Solvency Capital Requirement and Minimum Capital Requirement**

The Company commenced underwriting in April 2016. For a discussion and analysis of the Solvency Capital Requirement by risk module and sub-module, see section C - Risk Profile.

## E.3 Differences between the standard formula and any internal model used

The Partial Internal Model was approved by the PRA for use from 1 April 2020. It has been tailored to capture Flood Re's risk profile and provides the entity's economic view of capital.

***Solvency Position***

The table below sets out Flood Re's Solvency position against the Standard Formula and Partial Internal Model (Figures in £m):

| | 31 March 2022 | |
|---|---|---|
| | **Partial Internal Model** | **Standard Formula** |
| SCR | 68.2 | 61.6 |
| Eligible Own Funds | 613.6 | 613.6 |
| Solvency Ratio | 900% | 996% |

As shown, Flood Re is strongly capitalised, with the current and forecast Solvency Ratios, Own Funds and SCR, being materially above the Company's Risk Appetite.

***Risk modules***

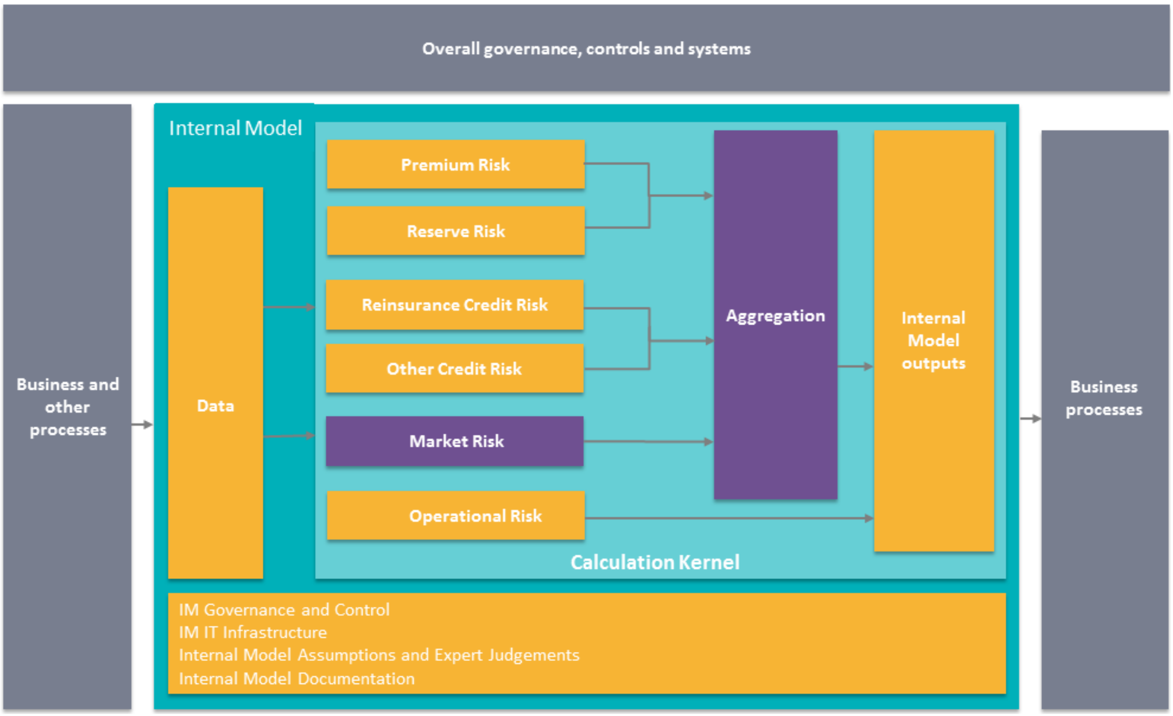
The following table sets out the assessment of each risk module and shows the combined SCR after allowing for both “intra-risk” and “inter-risk” diversification (Figures in £m).

| | | | |
|---|---|---|---|
| **SCR Risk Components £m** | | **31 March 2022** | |
| | | **Partial Internal Model** | **Standard Formula** |
| Premium/Cat Risk | | 34.5 | 49.9 |
| Reserve Risk | | 8.1 | 11.7 |
| Intra- Insurance Risk Diversification | | (4.0) | (7.6) |
| **Insurance Risk** | **C.1** | **38.6** | **54.0** |
| Reinsurance Credit Risk | | 4.7 | 1.5 |
| Other Credit risk | | 4.7 | 0.0 |
| Intra- Counterparty Risk Diversification | | (1.7) | (0.0) |
| **Counterparty default risk** | **C.3** | **7.7** | **1.5** |
| Market risk | **C.2** | 0.8 | 0.8 |
| Operational risk | **C.5** | 25.0 | 6.7 |
| Diversification | | (3.9) | (1.3) |
| **SCR** | | **68.2** | **61.6** |

Further details of the assessment of each risk module under the Partial Internal Model is given in Section C.

***Structure of the Partial Internal Model***

The Partial Internal Model includes the governance and systems around the model, as well as the Calculation Kernel which is where the actual modelling is performed. The Calculation Kernel is formed from a number of sub-models which are connected together; broadly speaking, each sub-model equates to a particular risk area with inputs from other sub-models or business processes. The overall SCR is calculated by aggregating the outputs of the different risk areas, taking into account any dependencies that may exist between them.




***Aggregation methodologies and diversification effects***

Flood Re could be exposed to more than one source of risk at the same time, either because a number of events happen at the same time by chance or because one event affects more than one risk area.

To ensure our SCR reflects our true potential financial losses, we therefore need to capture in our model:

- Which risk areas or risk types are related to each other; and
- The strength of these relationships.

The Flood Re PIM uses the Standard Formula correlation approach to aggregate the above risk modules within the PIM as detailed above. We consider this approach as appropriate to the nature and drivers of the individual risk elements. The table highlights that on average Flood Re gains a 6% inter-risk diversification benefit on a PIM basis, which is assessed as reasonable given the unique nature of Flood Re (single peril, single geography) and recognise that this is significantly lower than typically seen in the market.

Flood Re management recognise there is the risk of "model drift" over longer periods of time that reduce the capital requirements in less easily observed ways. Ongoing long-term monitoring of the PIM SCR against the standard formula provides an independent view of risk which the Flood Re Internal Model can be assessed against over future years. This is further supported by the tracking the capital requirements against defined metrics linked to Flood Re's underlying exposure to ensure that model has moved appropriately relative to its risk profile.

***Risks not covered by the standard formula but covered by the internal model.***

A number of elements of the Standard Formula SCR are limited in their reflection of Flood Re's risk profile. Whilst the Standard Formula gives a capital requirement broadly in line with that from Partial Internal Model as at 31 March 2022, we do not believe the Standard Formula to be appropriate for Flood Re's Premium Risk assessment.

The Company identified four areas where the Standard Formula was inappropriate, given the risk profile of the Company:

a. Non-life Premium and Catastrophe Risk
   With the Standard Formula being structured and calibrated to reflect an average European reinsurer, it does not appropriately reflect Flood Re's single Premium/Catastrophe Risk profile. The calibration for UK Flood in the Standard Formula is based on a broad, diversified portfolio which will not appropriately reflect the higher-risk portfolio of business that is expected to be written through Flood Re; the overall capital charge under the standard Formula is set at roughly 0.1% of the total insured value of the portfolio.

   The Standard Formula catastrophe risk module does not adequately assess the prospective benefit from the non-proportional reinsurance protection the Company has purchased as the risk scenarios are not severe enough to reach the Flood Re retentions.

   The Standard Formula does not recognise underlying economic profits generated by undertakings over a 12-month period. For Flood Re, the contribution from Levy I income means that the underlying probability of a financial loss is substantially lower than suggested by the Standard Formula.

b. Reserve Risk
   Following a year of relatively benign experience, Reserve Risk will typically be a smaller component of the total SCR due to:

   - The short-tail nature of flood claims meaning claims from prior year will be relatively mature in the path to ultimate development;
   - Reinsurance limiting the potential deterioration of reserves;
   - The relatively small size of the claims provision in the recent year; and
   - The diversification across different prior claim periods and events.

However, under stressed conditions (in particular where there are material claims arising from large very recent flood events where the information available is immature) it is highly sensitive to where the aggregate claim amounts lie relative to the retention on the reinsurance. For loss amounts under the reinsurance retention, there will be Settlement Risk but for loss amounts in excess of the reinsurance retention, the net Reserve Risk will be zero. As such, this unique relationship between reserves and their potential volatility is not appropriately reflected in the flat factor used by the Standard Formula.

c. Counterparty Credit Risk
The Standard Formula does not adequately assess the credit risk associated with the prospective benefit from non-proportional risk mitigation.

d. Operational Risk
- The Standard Formula uses premium and technical provision volume measures to calculate the Operational Risk charge. This is deemed inappropriate to Flood Re due to the high dependency on outsourced service providers.

## E.4 Non-compliance with the Minimum Capital Requirement and non-compliance with the Solvency Capital Requirement

For the years ending 31 March 2022 and 2021, the Company has complied at all times with the regulatory Minimum Capital Requirement and Solvency Capital Requirement.

There is no reasonably foreseeable risk of non-compliance with the Minimum Capital Requirement or Solvency Capital Requirement.

## E.5 Any other information

The increase in average claims costs anticipated as a consequence of COVID-19 in 2020 was less significant than originally expected. Outside of these claims costs, Flood Re has limited direct financial exposure to the impacts of COVID-19. This is due to the Company's single peril risk exposure, conservative investment portfolio, secure level of capitalisation and the Scheme's financial structure. In addition to the inflationary effects on average claims costs from COVID-19, and the wider economic environment, we continue to monitor for the potential influence of Brexit on future claims costs.

# F. Appendices – PUBLIC QRTs