Q1. Do you have any evidence of small businesses experiencing difficulty with the availability and affordability of property insurance due to the risk of flooding?

The Institute and Faculty of Actuaries (IFoA) does not hold any specific data to provide an empirical answer. Given that small businesses usually arrange their insurance as part of a wider package of insurance covers, we understand that this helps to make flood insurance generally available to this market.

The consultation explicitly excludes all commercial insurance from participating in the options under consideration. Whilst this may be a very simple distinction to enforce, it may exclude certain groups of people that could be considered within the overall policy given the spirit in which the policy objectives are set.

For example, many of the arguments applied to home owners also apply to those who are 'accidental landlords' - property owners that have chosen to rent rather than sell at a loss in a depressed housing market. Such accidental landlords may not necessarily be higher earners, as they may be a tenant elsewhere and, therefore, they are ultimately in the same 'net' ownership position as an owner-occupier. Excluding these landlords not only puts them at a disadvantage, but may also have adverse effects on their tenants (who may potentially be in lower income quintiles) should free market pricing leave buildings uninsured.

There is also a fine distinction between micro-businesses and private households; consequently, there is a need for greater clarity. Examples of such businesses could include sole traders operating businesses from their own homes, or home-run B&Bs.

Q2. Do you agree with the Government's policy objective for flood insurance?

The objectives of availability and affordability, in the short term, transition to risk-reflected pricing in the longer term. This means that the short term objective is in conflict with the longer term objective. It is important to have a smooth mechanism that enables the transition from short-term to long-term objectives.

If the transition to a free market is too gradual, there would be little incentive for homeowners to adapt their homes, or choose a different place to live. However, too fast a pace of change would reduce the affordability of flood insurance for those most affected.

Furthermore, if the objective were to move to a subsidy free regime in the very long run, the Government would still have to make significant investment in flood mitigation measures to ensure that the insurance remained affordable.

The overall policy objective encapsulates two very different ways of providing insurance. The short-term requires the cost burden to be shared to some extent by means of a subsidy paid by those in low flood risk to those in high risk, with a subsidy-free regime in the very long run.

The IFoA recently published research examining the concept of 'fairness' which describes these two opposing objectives.
(See http://www.actuaries.org.uk/research-and-resources/documents/e03-updating-discrimination-working-party-paper).

In recent times, the issues of fairness and equality in insurance pricing have been debated under significant public scrutiny. The research paper was published in light of that debate and outlines the IFoA's view in the context of general insurance, by which we mean all non-life consumer insurance products (such as motor insurance, household insurance and travel insurance). The intended audience for that paper was all interested parties, including policymakers, who do not necessarily specialise in insurance.

The key issue is determining what "fairness" means. Fairness is subjective and it is possible that an individual may view both sides of an argument to be in some sense "fair". Applied to insurance pricing, the concept of fairness creates two extremes.

The first extreme is an equal price for all regardless of the likely cost of claims, while the second is a specific price for each consumer in relation to the likely cost of claims in the period of insurance cover. Between these two ends of the spectrum lie many alternatives; the most common approach is the grouping of consumers using rating factors such as age, address, etc.

The paper does not try to determine which approach to insurance pricing is "fairest". Indeed, it is unlikely ever to obtain agreement among stakeholders in the insurance industry, including consumers. Instead, the paper seeks to explain how insurance is priced and to outline the consequences of changes to this approach. We conclude that it is for society and policymakers to determine what is fair and, therefore, to determine what the policy objective should be. The IFoA's aim is to help inform policymakers of the likely consequences of such decisions.

Q3. Do you agree with the approach taken to analysing the different potential solutions in the Impact Assessment?

The Impact Assessment (IA) contains a great deal of thought resulting in a detailed quantification of the costs and benefits of each potential solution. However, the IA is seeking to model the likely outcome of some very uncertain factors over a relatively long future period. The ranges of parameters that could be used in this assessment are therefore very wide and hence, the results could potentially be significantly different in practice.

The final bullet point of paragraph 105 on page 30 in the IA covers this point and is one that we would particularly endorse: '…the analysis is perhaps most useful as a framework for expressing the pro and cons of different approaches rather than as a set of firm numerical estimates.'

Q4. Do you agree with the evidence presented in the Impact Assessment?

The IA (page 4, paragraph 20) presents the argument that, as the current Statement of Principles does not constrain insurers on price, the likely pace of future change might be assumed to continue to follow recent experience. This leads to the pace of change as around 2% of high flood risk policies moving to risk-based terms each year.

Elsewhere in the IA (page 12, paragraph 43), a 'worst case' do nothing option is considered which transitions immediately to risk-based costing. It is our view that if nothing were done to replace the Statement of Principles, then insurers would seek to move relatively rapidly to a fully risk-based approach as they have in effect been suspending any material action pending resolution of previous uncertainty around the future of the Statement of Principles. Any significant flood event would further accelerate this change. However, as other free market situations have demonstrated, providers do not necessarily move to fully risk-reflective pricing for a variety of reasons including:

- Imperfect understanding/information;
- Reluctance to damage reputation;
- Desire to moderate price movements from one year to the next; and
- Taking a more holistic view of customer value across product holdings.

The IA questions whether 'unbundling' of flood cover would become widespread if a 'do nothing' approach were adopted. We believe that in the short term, insurers would be likely to continue offering flood cover, but they would look to adjust the levels of cover; either through raised excess levels, or reduced limits of cover. We would expect prices also to adjust as noted above.

One of the assumptions in the IA suggests that reinsurance cover under option 2 would rise (paragraph 64 onwards); however this seems somewhat counter intuitive. The aim is for insurance of the same risks to continue, but instead of direct insurers each ceding a portfolio of risks to the reinsurance market, the high risk policies would be ceded to the market via Flood Re. Therefore, reinsurance costs for direct writers should reduce as they no longer have these high flood risk policies.

For Flood Re (assuming aggregate cover levels are broadly unchanged), the reinsurance costs should be similar to the reductions to the direct writer costs. The overall business ceded to the reinsurance market would not materially change. It is true that the high flood risk policies would now be held separately, so Flood Re would not benefit from diversification with other risks (perils), e.g. fire or subsidence. The risk would be geographically diversified over the whole country and the reinsurers would still be able to diversify this risk with the other perils from the other business they write.

Some benefit may arise (under option 2) from the specialisation that comes from having all the high flood risk policies pooled together.

In practice, we might expect to see an interim increase in cost as there will be a significant change in the insurance/reinsurance environments. Change usually introduces uncertainty and, thus, prices may increase for a short period as a reflection of the need for extra prudence.

The IA (page 16, paragraph 55) states that the Flood Re proposal involves no risk retention for policies ceded to the pool, although the direct insurer would handle the claims from such policies. This would require Flood Re to ensure that insurers manage claims costs appropriately to avoid a vicious cycle of spiralling costs driving up premiums (pushing more properties over the threshold). *In extremis*, this might create an environment where insurers outsource to 'flood

Claims Management Companies' because it may save indirect costs with no immediate downside for the individual insurer. If this were to occur, it would increase the cost of household insurance and would be damaging to the industry and its customers. This could be exacerbated as there would be little incentive for insurers to put in place measures to manage down costs during "demand surge". This is illustrated by the increase in costs of claims handling and settlement in periods of high demand, such as those seen in extreme weather events in affected areas of the country.

Q5. Do you have any further evidence which has not been considered in the Impact Assessment?

The IFoA research (see response to Q2 above) includes the results of some consumer research carried out last year by Consumer Intelligence on behalf of the IFoA Discrimination Working Party (Sample 1,200 UK Motor Insurance Purchasers. June 2012 © Consumer Intelligence).

This included the following questions which addressed the issue of fairness in two forms:

A. "Everyone should pay the same for flood insurance vs. People who do not live in a flood area should pay less", and,

B. "Everyone should pay the same for flood insurance vs. People who live in a flood area should pay more".

In both cases, respondents (89%) were decisively of the view that the price people pay for flood insurance should depend on whether they live in a flood area. These results were also independent of gender and age.

A follow up survey this year asked a number of questions about experience and expectations of household flooding. It also asked 'Should people pay the same for flood insurance or should those who are more at risk of flooding pay more?' The results were:

- 9% of respondents stated that they live in an area which has been flooded during recent years;
- 43% of those who have been flooded stated that they are not in a high risk area;
- Of those who identified themselves as having been previously flooded and living in a high risk area, 73% stated that 'everyone should pay the same'; and
- Of those who identified themselves as not having been previously flooded and not living in a high risk area, 73% stated that 'those at risk should have to pay more'.

(Research on behalf of the IFoA Discrimination Working Party by Consumer Intelligence: Sample: 1,200 Motor Insurance Purchasers; April 2013 © Consumer Intelligence)

This research highlights how the concept of 'fairness' in insurance pricing is very dependent on the particular circumstances of the individuals concerned.

Q6. Do you support the Government's proposed approach?

The proposal does not make it clear how any levy would, in practice, be charged to insurers under Option 2. Whilst it is stated that the levy would be equivalent to around £10.50 per UK household, it is not clear if this would be applied in this form as an amount per policy, or converted into a percentage of premium income. The IA (page 17, paragraph 59) provides an alternative quantification of this as a 2.6% levy, which may imply the percentage of premium route is the envisaged way of collecting this. Whilst individual insurers would be able to build the levy into pricing to their policyholders in whatever form they choose, a levy as a percentage of premium has the merit of placing a higher charge (on insurers and hence potentially passed to policyholders in the same way) on larger policies, which would tend to correlate with the affluence of policyholders. This helps to target the levy so that more affluent people pay a larger share.

There may still be specific issues around the definition of the premium to which the levy is applied - for example, net or gross of commission. We also note that the levy is calculated on all household policies which include those for properties built after January 2009 and council tax band H properties, neither of which would benefit from the Option 2 solution. This may be a consideration in regard to the fairness point expressed in answer to question 5 above.

More detail is required on any additional levy required, if claims ceded to Flood Re exceeded its reinsurance limits, and how this would be divided up between the insurers. The impact of the potential for an additional levy could be sufficient to require insurers to hold additional capital or effect additional reinsurance (although currently there is no obvious reinsurance product to deal with the risk of an additional levy). This could have the impact of increasing customer premiums to a higher level than is expected from the levy. This could have a particularly detrimental effect for insurers who do not typically sell to flood areas as they may now potentially need to guard against this risk.

The proposed approach includes progressing the Flood Insurance Obligation option. The thinking on this appear less developed than those on Flood Re and our comments on this are contained in more detail in responses to later questions.

Q7. If the remaining challenges associated with Flood Re prove too difficult to overcome, what factors do you think should be taken into account ahead of any decision on whether or not to introduce the Flood Insurance Obligation?

More work is required to flesh out the details of this option. For example, one particular issue to be resolved is how high risk properties should be defined, as different flood maps assess flood risk differently. If households can opt in or out of any list, this could mitigate the problem in the longer term.

The Obligation could lead to a distortion in the market with unintended consequences. Not all properties on the list will be equally risky, so insurers will seek to identify the lesser risks and target these. If a company reaches its quota then its behaviour may change leading to uncertainty for individual policyholders.

It also introduces considerable uncertainty for customers at moderate flood risk who could end up paying higher premiums than those on the list.

Without certain controls around product design and minimum levels of cover, poorer products may be designed to target a company's quota of policies. If all insurers were compelled to sell to the high risk market, it would be more difficult for niche players to specialise in these risks. This could be to the detriment of consumers living in high risk properties. It also introduces considerable uncertainty for customers at moderate flood risk – who could end up paying higher premiums than those on the list could potentially benefit from the services of specialist flood insurers who might develop flood advisory and specialist claims response services. It may also be difficult for certain insurers without a proven track record to persuade the target market for high risk policies to request quotations.

Flood Re

Q8. Do you agree that setting the eligibility thresholds according to council tax bands (or their equivalents in the Devolved Administrations) will help ensure Flood Re support is targeted towards those households who need it most, without requiring significant administration? Is there a better method?

This would go some way to meeting the objective of targeting those households who need it most. As the consultation notes, the use of council tax bands is at best a crude proxy for affluence, but it would appear to be better than having no criteria.

The IA (page 18, paragraph 60) points out that the more affluent are likely to buy insurance and to have more expensive insurance. To some extent, any benefits would still accrue to the more affluent despite this council tax band targeting mechanism.

In order to minimise the administrative burden, the proposal to supply a database of council tax bands for each property is welcome. There would still be some costs incurred by the industry in introducing this change. Some insurers may find that for older legacy systems and/or closed books of business, it is not cost effective to apply this or indeed the flood element of the price is not calculated explicitly so they are unable to do this. However such policyholders, who live in high risk properties, would still have access to the subsidised premiums through the widely available open market route. Insurers are not obliged to cede all high risk business to the pool. So if they chose not to deploy the Flood Re option to their whole book they would be free to do so but they would still pay the levy and the flood claims for these policies.

As the aim is to move to a subsidy free regime in the very long run, there would be benefit to significantly increase these "eligibility thresholds" over time, thus phasing out the cross subsidy.

Q9. Do you have any views on the proposed initial "eligibility thresholds" within Flood Re (table 1 above), which would effectively cap the technical flood risk premium paid by high risk households?

We do not have the data in order to make an informed comment on the level of thresholds and the proposed levy – the two very much going hand in hand in any such evaluation.

Q10. Do you agree that the following should be excluded from Flood Re:

a. Band H properties?

b. New homes built after January 2009?

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

Excluding a. and b. maintains consistency with The Statement of Principles. This should continue to incentivise not building in flood prone areas, or do so in a way that helps to minimise flood losses. However, it is questionable as to whether the role of insurance is to influence where properties are built or whether this should be a subject for planning authorities. It might be argued as unfair that a homeowner buying a new build should find that they face very high insurance premiums either because the property has been built in a relatively high flood risk area, or at a later date, it should be deemed as such when previously it was not. We would therefore recommend that controls in planning should be considered in tandem with these measures.

The policy objective (referenced in Q2) looks to transition to a fully risk-based pricing over time. The exclusion of new homes built after January 2009 helps with this transition as, over time, a greater proportion of homes will be caught by this exclusion.

Excluding band H properties is based on the assumption that council tax band is correlated with affluence. We have already noted this is an imperfect measure and so there will be some poorer households excluded unintentionally.

Defining genuinely uninsurable properties may be problematic; however, it is understandable why these should be excluded. If the number of these is extremely small then any theoretical problem may prove to be immaterial. However, in theory, there would need to be a mechanism in place to clearly and unambiguously identify these, so that an insurer can quote for new business with the confidence that any risk it writes would be acceptable for ceding to Flood Re. Such a mechanism would need to be relatively inexpensive to administer.

Q11. Should other exemptions also apply?

No comment

Q12. Do you agree that Flood Re should apply to both buildings and contents insurance?

Yes. This seems easier to implement and ensures the benefit of flood insurance is available to a wider group.

Q13. Do you have any comments on this proposed way of managing Flood Re's exposure to large losses?

Managing the large losses through a reinsurance contract mitigates the need for the pool to quickly build up a large capital base. However, it will take many years for the funds to reach a sizeable level given such a large proportion of Flood Re's income will initially be used to purchase the reinsurance. The fund may still be at risk over this period of suffering significant losses through a series of small events as opposed to a single very large event, unless the reinsurance is structured to cater for this (and priced accordingly). We believe the level and cost of any reinstatements of cover should be considered, although there is no comment on these. Over time, if the experience of the fund is favourable, then the level of reinsurance cover purchased could also gradually reduce (by raising the level at which the reinsurance cover starts to bite). This would help to accelerate the build-up of the funds.

The reinsurer(s) would require a return on capital (or profit). Having such a large proportion of the risk reinsured means that, whilst the pool is a not-for-profit organisation, there is a significant element of profit (for the reinsurers) built in to the arrangement.

As was noted in the 'Independent Review of Flood Insurance Analysis" by Professor Stephen Diacon (page 5), the historic cost of catastrophe property reinsurance has fluctuated, often sharply, from year to year. These fluctuations should be considered in the context of the proposal to fix the levy for the first 5 years. This could result in the reinsurance cost exceeding the levy in any particular year.

The memorandum of understanding provides certain assurances about what would happen if there were an event larger than a 1 in 200 year period, but is vague on the details. Greater detail would be of assistance.

Q14. Do you think a levy equating to around £10.50 per UK household, which the ABI estimate is equivalent to the current cross-subsidy, is acceptable to help address the problem of securing affordable flood insurance for high risk households?

This depends on the definition and interpretation of fairness. In the calculations carried out, this is presumed to be an explicit quantification of the current implicit cross subsidy. There is at least greater transparency in this approach, although we do not have access to the underlying data to provide an opinion on the derivation of this amount.

As noted in Q9, the amount of the levy is directly linked to the choice of the eligibility thresholds.

As noted in Q6, the actual form of applying the levy has an impact – whether as a price per policy or a percentage of premium. If operating as a price per policy levy, particular consideration would need to be given to the share of the burden between those purchasing Buildings cover only, Contents cover only, Combined cover, or Buildings and Contents cover separately from different providers.

Q15. Do you agree that Flood Re will secure the availability and affordability of household flood insurance in the UK?

The proposal appears to meet this requirement in the near term. In the longer term, the affordability of flood insurance will ultimately depend on the extent of further mitigation measures, such as the level of investment in national flood defences. If investment in flood defences (bearing in mind the potential consequences of climate change) does not materially reduce the extent of flooding and associated damage during the proposed transition period, then insurance would be no more affordable for high flood risk properties at the end of the transition period that it would be now in a free market.

The planning authorities also have a part to play in ensuring that owners of properties built in the future (which by definition would not benefit from Flood Re) do not face high flood insurance costs due to location or design.

Flood Insurance Obligation

Q16: Do you agree that the Flood Insurance Obligation has the potential to meet the policy objective?

This Obligation may be able to achieve the policy objective, but it involves market distortion. This raises a number of concerns noted here and elsewhere in the response (in particular see response to Q7).

Whilst direct writers would be under an obligation to meet a quota, this presumably would not apply equally to reinsurers. There may be issues for companies placing their reinsurance.

Q17: Do you agree that the Secretary of State should have the power to exempt some firms operating in the UK domestic insurance market from the Obligation, e.g. those with market share below a *de minimis*?

Yes. Without this power it may be difficult for new entrants to come into this market which would stifle competition. There may also be other extenuating circumstances not envisaged at this time which such a power could reflect.

Q18. Do you agree that at this stage Ministers should have the option of applying the Obligation to both buildings and contents insurance?

Yes. if this is deemed reasonable using Flood Re then presumably it is also a requirement for the Obligation; otherwise it does not achieve the same outcome.

Q19: Do you agree that the Environment Agency should be granted powers to act as a „lead administrator?, working with the devolved administrations to compile a UK-wide register that lists by address each domestic property at high risk of flooding?

We would expect the industry to have a part to play, perhaps working with the Environment Agency in order to define high risk properties. Different insurers may be expected to have different views, which are likely to stem from their commercially bought flood risk models and/or their own internal models and data.

Q20. Do you agree with the broad duties envisaged for the regulator? Is anything missing?

No comment

Q21. Which of the above approaches to supervising compliance with the Obligation do you believe is best suited to delivering the policy objective whilst minimising the burden on businesses and consumers? Is there another approach not considered here?

No comment

Q22. Which of the above approaches to imposing sanctions for non-compliance with the Obligation do you believe is best suited to delivering the policy objective whilst minimising the burden on businesses and consumers? Is there another approach not considered here?

No comment

Q23. Do you agree with our preference that the Financial Conduct Authority should supervise compliance with the obligation, and be responsible for taking regulatory action against insurers who fail to meet their obligation, or should it be or the Environment Agency

The FCA regulates the insurance industry and hence, would seem a natural choice for supervising compliance.