LLOYD'S RESPONSE TO DEFRA CONSULTATION: "SECURING THE FUTURE AVAILABILITY AND AFFORDABILITY OF HOME INSURANCE IN AREAS OF FLOOD RISK"

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?

We do not have such evidence.

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

Broadly speaking, we agree with the policy objective.

We question the reference to "sustainable costs", because we do not think that the Government can limit the costs of flood to a level it considers to be sustainable. The costs of flooding, whether sustainable or not, arise from the natural environment and are largely beyond Government control (although spending on flood defences can help).

The policy described in this paper relates to mechanisms for spreading those costs across society. In considering how costs should be spread "perceived fairness" is probably a more pertinent consideration than sustainability.

The Government should explicitly consider the impact of policy costs on the insurance industry, as well as on policyholders and taxpayers. Otherwise, there is a risk of insurers being seen as a separate interest which can be tapped for finance without harm, even though the costs eventually fall on policyholders.

We therefore suggest re-stating the second sentence of this paragraph as:

"Government's objective is to ensure that domestic property insurance continues to be widely available and affordable in areas of flood risk without placing costs on taxpayers, the insurance industry or the wider community of policyholders that are perceived to be unfair."

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

We think that the Impact Assessment represents a reasonable and largely intellectually robust effort to assess the different potential solutions. Our analytical work on legislative proposals worldwide means that it is not uncommon for us to see Impact Assessments that are obviously drawn up to support preferred solutions of those commissioning the studies. We are pleased to note that this Assessment reads as an objective review of the four options identified.

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

We recognise that in some areas the Assessment is based on some largely arbitrary figures, as is inevitable in the circumstances. We do not think that this invalidates its conclusions, but we do believe that detailed deductions reached on financial aspects of the options should be viewed tentatively, even though the Assessment raises pertinent issues. Paragraph 79 describes the economic performance of Flood Re as “highly uncertain”: we think that some of the seemingly precise figures presented for other options are similarly uncertain.

We question assertions made about the purchase of reinsurance in paragraph 61. This says:

> *“Buying reinsurance would reduce the risk of large-scale losses, but would increase the frequency of smaller-scale losses as the costs of the reinsurance leave less levy income to meet claims from smaller events that fall beneath the reinsurance treaty excess. So while reinsurance helps smooth the losses, it means the pool is more likely to run into deficit over time…”*

Flood Re will be similar to, but not exactly the same as, a commercial reinsurer. Its exposure to catastrophe losses will be mitigated by the limitation of its annual liability to a 1:200 loss. It will nevertheless want to purchase reinsurance to limit fluctuations in its losses each year and to reduce the amount of capital it must put up to comply with UK and EU insurance solvency requirements.

The structure of Flood Re’s reinsurance programme will affect the likelihood of its running into deficit over time, but a decision to purchase reinsurance will not, in itself, make deficits more likely. If the purchase of reinsurance made it more, not less, likely that insurers would run into deficit, such purchase would be economically irrational and insurers would not buy it

We consider that the pool is more likely to run into deficit if it decides not to purchase reinsurance and then sustains either one or two substantial losses or a series of smaller, but nevertheless serious, attritional losses in a given year. For example, the US National Flood Insurance Program does not purchase reinsurance and has accumulated cumulative debts of $17.75bn, following catastrophic losses in 2005, 2008 and 2011.

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

We do not have any further evidence.

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

We support the Government's preference for working with the insurance industry to secure the affordability and availability of flood insurance. We therefore support the establishment of Flood Re to provide reinsurance of households at higher risk of flooding.

For reasons set out in this response, we are firmly opposed to the Flood Insurance Obligation.

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?

For many reasons, the Government should think very carefully before imposing the Flood Insurance Obligation (“FIO”) on insurers:

1. **The FIO is contrary to the philosophies and approaches of successive UK Governments:** The FIO means that the UK Government will impose a legal obligation on businesses to enter into contracts to provide services at less than their economic cost. The consultation hugely underplays the implications of a UK Government legislating in this way.

   Successive UK Governments have supported the free market and sought to avoid heavy-handed intervention in the decisions of individuals and businesses within the market. The existing Coalition Agreement, for example, talks about a shared conviction that *"…centralisation and top-down control have proved a failure"* and a belief that business is *"…the driver of economic growth and innovation*". This proposal is counter to those principles.

2. **The FIO will constitute a dangerous precedent, domestically and internationally:** The Government should consider carefully the message that the FIO would send about its attitude to free markets. Its actions will be observed by interested parties such as potential foreign investors in the UK and other Governments of countries in which UK firms carry on, or seek to carry on, business. The FIO would be a precedent for punitive regulation, requiring insurers and other businesses to enter into contracts when they do not wish to do so, in the pursuit of public policy objectives.

3. **The Impact Assessment does not suggest that the FIO is better than other options:** It is not clear why the Government has selected the Flood Insurance Obligation as its default option should Flood Re prove to be unworkable. The Impact Assessment does not suggest that it has obvious advantages over options 1 and 3. The insurance industry will not welcome option 4, so imposing it on insurers will be directly contrary to the Government's stated preference for working with the insurance industry.

4. **The FIO will be arbitrary and unfair:** The "obligation target" will not be an objective number and its selection will be influenced by all sorts of considerations, including political factors. Individual insurers' targets could also be open to legal challenge, particularly if some insurers are exempt. Achieving targets is likely to mean insurers charging medium- and low-risk households higher premiums than high-risk properties, which many policyholders will consider unfair and which will dis-incentivise flood risk reduction for high risks. Insurers may miss targets through no fault of their own (for example, because an insufficient number of high-risk households seek to purchase insurance), incurring penalties that will seem arbitrary.

5. **The FIO risks reducing the availability of property insurance:** It will encourage insurers to exit the market or to reduce their market share, to minimise their exposure to the Obligation.

6. **The FIO will place UK-based insurers at a competitive disadvantage:** The FIO will be difficult to apply to insurers based in other EEA member states (including Gibraltar) underwriting UK household insurance on a branch or services basis. These insurers will therefore have a competitive advantage over UK-based insurers, encouraging the movement of insurers offshore, to the detriment of the UK industry and employment within the industry.

7. **The FIO will complicate UK regulation of the insurance industry:** The UK has recently revised its financial regulatory system, putting in place two supervisory authorities, with explicit objectives:

   The Prudential Regulatory Authority:

   - To promote the safety and soundness of regulated firms: and
   - To contribute to the securing of an appropriate degree of protection for policyholders.

   The Financial Conduct Authority:

   - **Strategic objective:** To ensure that the relevant markets function well.
   - **Operational objectives:**
     - To secure an appropriate degree of protection for consumers.
     - To protect and enhance the integrity of the UK financial system.
     - To promote effective competition in the interests of consumers.

   The FIO will introduce a new regulatory requirement which is directly contrary to many of these objectives.

   When the Government introduced the new regulatory system, it stressed the need for regulators to have a narrow set of strategic and operational objectives, to ensure that regulators have a clear mandate and focus[1]. Introducing new regulatory objectives and obligations that run counter to those in place is contrary to that approach.

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?

Yes

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?

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

a. **Band H properties?**

   Yes.

b. **New homes built after January 2009?**

   Yes.

[1] See e.g. p. 46, *A new approach to financial regulation: building a stronger system*, HM Treasury, February 2011

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

Yes.

It will be hard to frame an appropriate definition. A possible approach would be to exclude any property that has sustained material flood damage (which will require definition) three or more times in the 10 years prior to quotation. The number of "uninsurable properties" may grow over time, in line with predictions around the impact of climate change.

Q11. Should other exemptions also apply?

No.

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

Yes.

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

Claims exhausting Flood Re's funds

Page 28 of the paper mentions a situation in which *"…Flood Re has insufficient funds to meet the costs of claims before its own reinsurance policy is triggered*", when it says that insurers would have to make ad hoc additional contributions. This situation is not mentioned at all in the section on page 40 on "*Managing Flood Re's exposure to large losses*". It represents a potentially significant exposure to insurers reinsured by Flood Re and needs further analysis for insurers to understand its implications.

Flood Re's 1:200 loss

Further work is needed on what happens if Flood Re's 1:200 loss is reached and it is no longer liable to pay out on its reinsurance contracts. Insurers reinsured by Flood Re will be legally liable to meet policyholders' flood claims, without reimbursement from Flood Re. Detailed assessment will ensure that insurers and those monitoring them, such as prudential supervisors and credit rating agencies, can make appropriate provisions for this eventuality.

The "1 in 200 year loss scenario" is the aggregated annual modelled loss for Flood Re, based on its anticipated portfolio of insured property (We suggest that this is made clearer, as it could have other meanings). It will include the consequences of several floods occurring in a single year, none of which is a 1:200 loss, but which in aggregate breach the 1:200 level. There will need to be arrangements for the proportionate reduction of claims payments and for how Flood Re will operate if, in a particular year, Flood Re's aggregate claims look like approaching a 1:200 loss.

Flood Re's reinsurance

Flood Re's purchase of reinsurance will be an important element in its strategy for coping with large losses. Its reinsurance programme should be carefully structured in light of its regulatory capital requirements, to ensure that it achieves optimal outcomes. We suggest that a dialogue is initiated with potential providers of reinsurance cover.

Government support

The Government has not committed to make available any additional resources at the 1:200 loss point, so the full cost of extreme event is likely to fall on the insurance industry. This reinforces the need for a good understanding of the consequences of a 1:200 being reached. Although we understand the reluctance of the Government to commit to providing a financial backstop, such a commitment would enhance the financial credibility of the scheme.

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?

It is difficult to predict whether households will find this levy acceptable to secure affordable flood insurance for high risk households. If it is truly the same as the current cross-subsidy, premium increases should be minimised, facilitating acceptance.

The scheme should be transparent. The levy should be itemised on insurance documentation received by policyholders and the level of subsidy should be made clear to flood-exposed policyholders whose premium has been capped. This will help to reduce the risk that economic incentives are maladaptive.

We assume that the levy will be charged at the same rate on all household policies, including those paying reduced premiums under the Flood Re scheme (i.e. the levy will be on top of the maximum premiums per Council Tax Band quoted elsewhere) and households automatically excluded from Flood Re, such as those in Council Tax Band H and in buildings constructed since 2009. Should some households be exempt from the levy, the costs to the remaining households would be increased.

A further question is whether a levy at this level will be sufficient. In aggregate, the amount raised should cover the difference between premiums received by Flood Re for reinsuring high-risk property and the premiums that it would charge on a risk basis. Although Flood Re is described as “not-for-profit”, it may be sensible for Flood Re to aim to produce a small surplus each year, for reinvestment as capital. Targeting the break-even point could be challenging and may entail a series of deficits, which would be met by ad hoc levies on premiums, likely to be less acceptable than those announced some time in advance.

We note the statements that:

> *“Insurers would only be able to reinsure policies through Flood Re if they charged households a set price for the flood component of their insurance policy…the insurer would pass the flood risk element of the household policy to the Flood Re pool, together with a premium equal to the relevant eligibility threshold”.*

In fact, insurers will not be able to pass 100% of the flood risk element to Flood Re. Insurers will retain exposures to credit risk, to Flood Re requiring ad hoc additional insurer contributions and to flood costs exceeding Flood Re’s 1:200 loss. Careful consideration should therefore be given to whether it is prudent for insurers to receive no premium whatsoever to cover these exposures. It may be more appropriate for insurer to make a charge for them.

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

We believe that Flood Re could help to make household flood insurance more available and affordable in higher-risk areas in the UK.

Flood Insurance Obligation

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

No. As pointed out in response to Q7, the FIO risks reducing the availability of property insurance and will place costs on insurers that will ultimately fall on wider policyholders.

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*?

No comment.

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

For reasons stated earlier, we do not consider that the FIO should be applied to either buildings or contents insurance.

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?

As we do not support this option, we do not consider that the Environment Agency should have these powers. Nevertheless, in general we are in favour of the Environment Agency working with the insurance industry and its risk models.

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

We consider that the imposition of the FIO as a regulatory obligation would constitute a fundamentally improper misapplication of the concept of financial regulation.

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?

As we have made clear, we oppose imposition of the FIO in its entirety.

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?

See previous responses.

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?

It would be entirely wrong to appoint the FCA to supervise compliance with this obligation. The FCA has only recently been established and already has a challenging programme of work to achieve its objectives. Adding an additional responsibility which has nothing to do with those it already has can only make it more difficult for it to operate effectively. As noted earlier, the Government sensibly wants the supervisory authorities it has established to maintain their focus. Placing new obligations on the FCA is contrary to this.

It is important to recognise that the FIO does not constitute “consumer protection”. The FCA describes consumer protection in financial services as being about ensuring *“…consumers don’t fall victim to scams or get tied in to unfair contracts.*” The FIO is about neither of these laudable aspirations. Instead, it requires insurers to offer insurance to high risks at premiums below what they would choose to charge.