Department for Environment, Food and Rural Affairs

Water Bill

Flood Insurance: Flood Re - Finance and Accountability

December 2013

This note builds on information provided in the Flood Insurance note published in November (PB 14066).

Contents

How does Flood Re work?...1

What is the top-up levy, and why is it needed?..1

Why are these funding arrangements being proposed? 2

What arrangements are proposed for Flood Re to enable it to operate as an industry body whilst managing public money?..2

Why are these novel arrangements being proposed? 3

How does Flood Re work?

Flood Re would be operated as a not-for-profit reinsurance scheme managed by the insurance industry. This means that Flood Re would allow insurers to transfer the premium they receive for the flood risk part of home insurance policies to Flood Re and, in return, Flood Re would reimburse insurers for flood claims that they pay to their customers in relation to such policies. Flood Re would not have any direct relationship with customers itself.

The industry advises that lower risk households are already subsidising those at higher risk of flooding, partly because of the market environment created by the current Statement of Principles. This, however, exists on a purely voluntary basis and would start to unwind over time because of the pricing pressures of a competitive market. The Flood Re scheme would replace this cross-subsidy with a statutory levy to create a level playing field across the whole insurance industry by preventing new entrants from gaining an advantage at the expense of existing insurers who to date have sold high risk policies at a loss.

The level of this levy (Levy I) would be agreed between Flood Re and Government, and has initially been set at £180m p.a. for the first five years of Flood Re's operation (the equivalent of around £10.50 for each UK household with both buildings and contents insurance in place). This levy will be used, alongside Flood Re's premium income, to buy reinsurance, pay claims, and fund the running of Flood Re.

Should Flood Re's funds and reinsurance cover be unable to fully meet its outgoings (i.e. below the estimated £250m lower limit on its reinsurance), Flood Re would charge each of its member firms an additional amount to make up the shortfall, known as the 'top-up levy'.

What is the top-up levy, and why is it needed?

The top-up levy (Levy II) would enable Flood Re to raise funds from all insurers (in proportion to their Levy I payments) in situations where Flood Re does not have sufficient funds to meet its liabilities, below the estimated £250m lower limit on its reinsurance.

The top-up levy is designed to ensure that Flood Re has access to funding in emergency circumstances when the FR Scheme is running out of money. For prudential reasons it would not be possible for prior Parliamentary approval to be sought by Flood Re for each individual call on the top-up levy, as this might leave open the very real risk that Flood Re could become insolvent and be unable to pay claims. However, it is proposed that Parliament would approve a framework of controls, to ensure the circumstances under which the top-up levy might be called upon are limited to fulfilling Flood Re's purposes, and only when necessary – see New Clause 3, paragraph 2.

It is also proposed that, should Flood Re be required to call on the top up levy and subsequently build up a sufficient surplus (in future years), insurers' top-up levy contributions should be able to be paid back to them by Flood Re. This is as set out in the June Memorandum of Understanding (MoU) (agreed with the ABI) that "the overall effect [of the top up levy] on insurers is neutral over time". There would need to be an expectation that such contributions could be paid back to insurers at the discretion of the Directors of Flood Re, within the terms of the Scheme, and providing that Flood Re had built up sufficient capital such that it would not be prudentially detrimental to do so.

Why are these funding arrangements being proposed?

The proposed approach to Flood Re's financing aims to strike a balance between the need to minimise the impact on households, manage the impacts on the public finances, and meet insurers' aim of minimising volatility for their profit and loss accounts.

The arrangements proposed by the industry for the top-up contributions would smooth the impact on insurers' finances, by allowing them to avoid having to record unplanned expenses within a given year as a result of providing top-up contributions through Levy II.

The MoU sets out the Government intention not to unfairly penalise insurers for making top-up levy payments in a way that could impact on household bills. These proposals achieve that outcome, in a way that doesn't create a new liability for Government.

What arrangements are proposed for Flood Re to enable it to operate as an industry body whilst managing public money?

The MOU with the ABI says that Flood Re will be established as an industry-owned and managed body, and that it will need to be established in a way which meets standards for accountability which are acceptable to Parliament. Ministers wrote to the relevant Parliamentary Committees in June, following publication of the MOU, setting out our proposals in this area, which we can now set out in more detail below.

Because a large part of Flood Re's income would be from the statutory levy (Levy I), it is likely that the Office of National Statistics would consider some or all of Flood Re's funding as tax and therefore some or all of its expenditure as public expenditure. It is therefore appropriate that there are appropriate controls in place to control its finances and ensure accountability is clear.

It is proposed that Flood Re would be operationally independent, in line with the insurance industry's aim. Clearly this has novel implications for accountability and scrutiny arrangements; with less direct Government management oversight and accountability than would be expected for a conventional arm's length body, with Flood Re itself having a greater level of direct accountability to Parliament.

Relevant Ministers would be accountable to Parliament concerning general policy matters relating to flood insurance, with Defra's Accounting Officer accountable to Parliament for the net expenditure for Flood Re as reported in Defra's Accounts. However, as an industry-owned and managed entity, Flood Re itself would be accountable to Parliament for the detail of its operations (e.g. through scrutiny by the Public Accounts Committee).

The proposed Scheme is being set up with economy, efficiency and effectiveness at its core, but with the overall focus of ensuring affordable flood cover remains available in the UK while minimising the costs of doing so.

Flood Re will be required to appoint a Responsible Officer (expected to be its Chief Executive Officer) who will be directly accountable to Parliament for the economy, efficiency and effectiveness with which it uses its resources in the discharge of its functions.

The Comptroller and Auditor General may scrutinise how income classified as public funds has been deployed in practice, undertaking value for money reports assessing the economy, efficiency and effectiveness of Flood Re, and if it has acted with regularity and propriety in the discharge of its duties. Flood Re will have to provide access to documents and any assistance required by the NAO. It is also intended that Flood Re would be required to lay its accounts in Parliament, prepared to the standards required of private companies and audited as representing a true and fair view.

The level of Levy I, and certain aspects relating to Flood Re's finances (e.g. borrowing, losses and accounting) will be regulated because of the potential impact on public finances. The finer details of the proposed controls around these arrangements are the subject of further discussion with the industry.

As a body established and run by the private sector, functioning fully as a reinsurance company, Flood Re would be regulated by the financial regulators (the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA)).

Why are these novel arrangements being proposed?

The proposed approach aims to strike a balance between the requirements of accountability to Parliament, and the need for Flood Re to be able to operate as an integral part of the insurance market.

This document/publication is also available on our website at:

https://www.gov.uk/government/policies/reforming-the-water-industry-to-increase-competition-and-protect-the-environment/supporting-pages/reform-of-the-water-market-the-new-water-bill

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