EXPLANATORY MEMORANDUM TO

THE FLOOD REINSURANCE (SCHEME AND SCHEME ADMINISTRATOR DESIGNATION) REGULATIONS 2015

2015 No. [XXXX]

THE FLOOD REINSURANCE (SCHEME FUNDING AND ADMINISTRATION) REGULATIONS 2015

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1. This Explanatory Memorandum has been prepared by the Department for Environment, Food and Rural Affairs and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 The Flood Reinsurance (Scheme and Scheme Administrator Designation) Regulations 2015 ("the Designation Regulations") and the Flood Reinsurance (Scheme Funding and Administration) Regulations 2015 ("the Funding and Administration Regulations") provide for the establishment, funding and administration of a reinsurance scheme which is intended to facilitate the provision of affordable flood insurance for domestic properties at high risk of flooding.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Context

4.1 The two Statutory Instruments considered by this Explanatory Memorandum implement provisions in Part 4 (Flood Insurance) of the Water Act 2014 ('the Act').

4.2 The Designation Regulations establish, for the first time, the Flood Reinsurance Scheme ("the FR Scheme") and appoint the FR Scheme administrator to manage the FR Scheme. The Funding and Administration Regulations provide the FR Scheme administrator with powers to raise a levy from the insurance industry to fund the FR Scheme and set out the conditions by which the FR Scheme must be managed, including how the FR Scheme administrator will be directly accountable to Parliament. The Funding and Administration Regulations also make a minor amendment to section 69(3)(d) of the Act, using powers set out in section 69(4) of the Act, changing the reference from "National Land and Property Gazetteer" to "National Address Gazetteer".

4.3 During the passage of the Act through Parliament,[1] the Government committed to setting out details of the requirements which would be placed on the FR Scheme and the FR Scheme administrator in Regulations, including on review, transition to risk reflective pricing, financial governance arrangements and some definitions. The Funding and Administration Regulations reflect these commitments.

4.4 The Regulations should be read alongside the "Scheme Document" which describes the Scheme which is designated by the Secretary of State under the Designation Regulations, and which is annexed to this Explanatory Memorandum. The Scheme Document provides more detail on how the FR Scheme will operate, including eligibility for the FR Scheme both in terms of ceding policies and funding the FR Scheme.

4.5 In order to operate as a reinsurer, once designated, the FR Scheme administrator will need to obtain authorisation from, and subsequently be regulated by, the relevant financial regulators (the Prudential Regulatory Authority and the Financial Conduct Authority). As an authorised reinsurer it will operate under the relevant financial services legislation, including the Financial Services and Markets Act 2000.

5. Territorial Extent and Application

5.1 These instruments apply to all of the United Kingdom.

6. European Convention on Human Rights

6.1 The Secretary of State for Environment, Food and Rural Affairs has made the following statement regarding Human Rights:

In my view the provisions of the Flood Reinsurance (Scheme and Scheme Designation) Regulations 2015 and the Flood Reinsurance (Scheme Funding and Administration) Regulations 2015 are compatible with the Convention rights.

7. Policy background

7.1 Recent large scale flood events highlight the impact of severe flooding, including on those who struggle to find affordable insurance. It is therefore important to ensure that people are able to take steps to manage the risk of flooding, including through access to affordable flood insurance.

7.2 Flood insurance has previously been widely available to properties at high risk of flooding due to a series of voluntary agreements on the provision of insurance between Government and members of the Association of British Insurers (ABI)[2]. The most recent

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[1] Transcripts of the Parliamentary debates can be found at the following link: http://services.parliament.uk/bills/2013-14/water/stages.html

[2] The ABI is the representative body of the insurance industry. We have been consulting with the ABI as a key stakeholder because it has led, on behalf of the insurance industry, on the initial set up of Flood Re Limited, the

of these was the 2008 "Statement of Principles" agreement. However, the Statement of Principles did not cover the affordability of insurance and there were various conditions attached.

7.3 Flood insurance has also previously been more affordable due to a lack of detailed information on flood risk which led to an informal cross-subsidy operating in the market between customers at low risk of flooding and those at high risk. Recent improvements in insurers' understanding of flood risks mean that insurance costs are becoming increasingly "risk reflective". This, coupled with the intended expiry of the Statement of Principles, means that some properties at higher flood risk could face unaffordable increases in insurance premiums. In addition to this, the Statement of Principles applied only to ABI members (currently 79% of the UK home insurance market). New entrants to the market since the Statement of Principles was agreed in 2008 as well as non-members of the ABI have been able to offer insurance without being subject to the voluntary agreement to offer flood cover under the terms of the Statement of Principles.

7.4 A renewal of the voluntary Statement of Principles agreement would therefore not address affordability for those facing rising premiums, or the market distortion created by it, and an alternative solution was sought. A number of options were considered and the Government's preferred approach was to introduce legislation which would create a FR Scheme to support households at highest flood risk and manage a transition to more risk reflective pricing over a 25 year period. The legislative approach (through powers in the Water Act and these Regulations) was considered the most effective way of ensuring that the existing cross-subsidy continues over a transitional period and will place all insurers in the market on equal footing in sharing the cost of insuring high flood risk properties.

7.5 The Act provides powers to establish a reinsurance scheme for domestic properties, called the "FR Scheme". The FR Scheme will provide insurers with the ability to purchase subsidised reinsurance from the FR Scheme administrator and therefore pass the risks of those policies to the FR Scheme, and so allow insurers to pass the savings (in the form of limited premiums for the flood risk element of their policy) to consumers. Our analysis, based on extensive industry modelling, is that the FR Scheme could facilitate affordable flood insurance for approximately 348,700 properties[3]. The benefits of the FR Scheme will be targeted towards lower income households; those in lower property valuation bands receive proportionately more support. This is to help promote affordability for those who are least able to pay.

7.6 Part 4 and the Schedule to the Funding and Administration Regulations set the maximum levels which the FR Scheme administrator can charge relevant insurers for the cost of reinsurance. These levels are set in relation to a property's valuation band (or equivalent arrangements in each Devolved Administration). The Funding and

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company which is designated as the FR Scheme administrator by the Secretary of State in the Designation Regulations.

[3] Figure based on data used in the consultation stage Impact Assessment for these Regulations.

Administration Regulations also set the formula for annual increases to these premiums, linked to the Consumer Price Index.

7.7 Insurers will maintain a direct relationship with their customers, with policyholders paying premiums and making claims directly to their insurer. An insurer may choose to cede the flood risk element of a contents policy, buildings policy or combined policy to the FR Scheme, however, it is intended that they will only cede the flood risk element of a policy to the FR Scheme if they believe that this flood risk element will cost more than the premium set under the FR Scheme. In the event of a flood, the insurer would pay the claim to its customer and seek reimbursement from the FR Scheme. The presence of the FR Scheme therefore should not change the nature of customers' relationship with insurers.

7.8 Funding for the FR Scheme will come from the ceded premiums (as described above) and a levy, which will be raised from home insurers according to their market share. The levy will be set at a level that the ABI assures Government replicates the cross-subsidy that already exists in the market. As such, the price of home insurance should not increase for those properties at no or low flood risk as a result of the levy. This levy will be £180 million each year for the first five years of the FR Scheme, and subject to review at least every five years thereafter. Should further funding be required, the FR Scheme administrator can also call on insurers to provide it with additional funding in the form of an additional levy or contributions.

7.9 The FR Scheme is a transitional scheme. The FR Scheme administrator must therefore produce a "Transition Plan", detailing how it will manage the transition to risk reflective pricing. To help customers prepare for the end of the FR Scheme, the Funding and Administration Regulations require the FR Scheme administrator to provide insurers who cede polices to the FR Scheme with information on flood risk and steps homeowners can take to mitigate the effects of flooding (as well as information on the FR Scheme itself). It is expected that insurers will pass this information on to their customers.

7.10 The Funding and Administration Regulations set the legislative framework in which the FR Scheme will operate and carry out its functions and how it will be accountable to both Government and Parliament. The FR Scheme will be industry-run and led, as a company limited by guarantee ("Flood Re Limited"), and there will be no Government role in the FR Scheme's day-to-day management. The FR Scheme administrator will be directly accountable to Parliament for the way the FR Scheme is run and managed. The Funding and Administration Regulations require the FR Scheme administrator to appoint the person acting as its Chief Executive Officer as a "Responsible Officer", who will have responsibilities akin to an Accounting Officer within Government and as set out in the HM Treasury publication "Managing Public Money"[4]. These arrangements provide Parliament with direct oversight of the FR Scheme and the FR Scheme administrator. The Funding and Administration Regulations set out how the Responsible Officer will be held to account and the standards by which the

[4] The publication can be found at: https://www.gov.uk/government/publications/managing-public-money

management of the Scheme will be assessed, by Parliament and the National Audit Office.

7.11 The Funding and Administration Regulations establish the process for reviewing the FR Scheme, requiring the FR Scheme administrator to review the FR Scheme's finances at least every five years (although a review can be called at any time). As part of the review process, the FR Scheme administrator will need to consider how any changes in the finances of the FR Scheme feed into the transition of the Scheme in line with its Transition Plan. Any changes to the parameters of the FR Scheme resulting from the recommendations of a review will be made by Regulations subject to the affirmative procedure.

State Aid

7. 12 Under European Union State Aid rules, the levies paid into the FR Scheme could constitute State resources which could be seen as giving a selective advantage to insurers offering flood insurance in the United Kingdom. The European Commission approved the Government's notification of State Aid on 29 January 2015. The Commission accepted that such insurance cover may not otherwise be sufficiently available on the private market and concluded that the design of the scheme was in line with EU State Aid rules. The Government expects that a supplementary notification will be made to cover minor subsequent changes to the design of the FR Scheme which were made in December 2014.

8. Consultation outcome

8.1 The consultation on these Regulations followed a separate consultation on the proposed approach to address the future availability and affordability of flood insurance (which ran between 27 June and 8 August 2013), and a consultation on the draft clauses for inclusion in the Water Bill (which ran between 6 September and 25 October 2013).[5] There was strong public support for the proposed approach with 67% of respondents agreeing with it.

8.2 The public consultation on these Regulations was launched on 22 July 2014 and lasted eight weeks, closing on 16 September 2014. 80 responses were received. The responses were broadly split between the insurance industry, private individuals and those involved with floods policy and/or management (Local Authorities, community groups at flood risk and national flood action groups). As part of the consultation process, Defra held separate discussions with insurers, and with representatives of national flood action groups and associated interests, during August and early September 2014. Officials also engaged with insurance brokers and representatives from the Lloyd's market to ensure there was a comprehensive view of the insurance sector. Additionally, officials met representatives of the property and mortgage sector and small business representatives to

[5] Details of the original public consultation, the consultation on the draft clauses, and the Government response can be found at: https://consult.defra.gov.uk/flooding/floodinsurance

discuss their insurance needs and Government's proposals to monitor the insurance market.

8.3 Some respondents suggested technical amendments to the draft Regulations. The key amendments made in light of the consultation, on financial governance and eligibility, are set out below. Further changes, mainly technical in nature, have also been made and are set out in the formal response to the consultation, which is available on the Gov.UK website.[6]

8.4 On the **financial governance framework** for the FR Scheme, the consultation made clear that the restrictions on the FR Scheme's ability to add more than £100m to Public Sector Net Borrowing (PSNB) were an area of ongoing dialogue with the industry. The Government worked intensively and constructively with Flood Re Limited and the ABI and agreed that protection for public expenditure should instead be provided by the purchase of appropriate reinsurance. The FR Scheme administrator's Articles of Association will include a provision which will require that the FR Scheme administrator must purchase appropriate reinsurance (or equivalent cover with the same effect), providing that such reinsurance is affordable and available, so that the FR Scheme does not have an impact on PSNB greater than the "loss limit" at the end of any one financial year. The "loss limit" will be set through an agreed review process which at the outset will involve a validation of an initial loss limit of £100 million.

8.5 In terms of **eligibility for benefitting from reinsurance through the FR Scheme**, we have considered the concerns raised through both consultations and during the passage of the Act through Parliament about the impact on households in Band H (and Band I in Wales) properties of paying towards the FR Scheme and facing high insurance premiums in flood risk areas. The insurance industry has provided assurances that the inclusion of Band H and equivalent properties would not affect the £180 million levy on the industry and that properties in lower property valuation bands would not be subsidising Band H and equivalent properties. The Government has agreed that, provided these conditions are met, the policy can be changed and Band H and I properties will now be eligible for the FR Scheme. Some changes have also been made to the definitions of "home insurance" and "household premises" to clarify the policy intention of who will be required to pay the levy and which properties will be eligible to benefit from the FR Scheme.

9. Guidance

9.1 The Scheme Document, attached to this Explanatory Memorandum, provides further detail on how the Scheme will operate. The FR Scheme administrator will engage with insurers through a programme of workshops, conferences, webinars and wider communications designed to integrate insurers' operational processes and systems with the FR Scheme. The FR Scheme website will contain further information for insurers and

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[6] The Government's response to the consultation on the draft Regulations can be found at: https://www.gov.uk/government/consultations/flood-insurance-Regulations-for-the-flood-reinsurance-scheme

will include a data portal for insurers who use the FR Scheme, where detailed operational process information will be stored. As noted in paragraph 7.9, the FR Scheme administrator will provide insurers who cede polices to the FR Scheme with information on flood risk and steps homeowners can take to mitigate the effects of flooding (as well as information on the Scheme itself). It is expected that insurers will pass this information onto their customers.

10. Impact

10.1 As a tax measure, an Impact Assessment (IA) is not required for these Regulations. However, IAs were prepared to inform consultees during the consultation processes. The most recent IA (which is available on www.gov.uk) is attached to the Explanatory Memorandum, alongside a note setting out updated costs, assumptions and implications based on data provided to Government by the ABI in December 2013. The IA will also be published alongside the Explanatory Memorandum on www.legislation.gov.uk

10.2 As set out in the IA, and based on these figures, net costs of underwriting the separate pool liability for the FR Scheme are estimated to be up to £16-49million per year compared with covering the same risks under the baseline (where they would be pooled with non-flood risks). Administrative costs of setting up the pool (£8-12million), then running the pool (£6-10million per year) plus costs of collecting levies (~£1million per year) are borne by the FR Scheme. The FR Scheme is projected to deliver annual benefits of £10million per year. The cost of the levy is excluded as this is a transfer payment.

10.3 Because the IA shows that the quantifiable costs are greater than its estimated benefits, and as set out in the passage of the Act through Parliament, a Ministerial Direction may be required for the FR Scheme on value for money grounds. However, as set out at the time[7], Ministers have been clear that the FR Scheme provides the best option for meeting the wider public interest in securing the availability and affordability of home insurance in areas of high flood risk. The FR Scheme will reduce the uncertainty facing individuals and communities in areas of high flood risk and the wider social and economic impacts which that uncertainty could have, for instance, on the housing market.

10.4 The impact on the public sector is estimated to be negligible.

11. Regulating small business

11.1 These Regulations are concerned with the provision of home insurance since the FR Scheme is designed to support those properties at the highest flood risk in the home insurance market only; a separate market exists for commercial insurance and therefore small businesses and other types of policies which are classed as commercial by the

[7] Transcript of Second Reading of the Water Bill in the House of Commons 25 November 2013: http://www.publications.parliament.uk/pa/cm201314/cmhansrd/cm131125/debtext/131125-0002.htm#13112514000001

industry (such as those for buy-to-let properties or large blocks of flats) are not eligible for the FR Scheme. In respect of some small businesses that may be affected by the withdrawal of the current Statement of Principles agreement, the Government committed to monitoring the market for flood insurance for these groups. The results of this monitoring will be published in due course.

11.2 The Regulations place requirements on insurance companies operating in the home insurance market, the vast majority of which are large international firms. At present we are not aware of any "relevant insurers" under the FR Scheme that would be classified as small businesses, and therefore do not envisage that there will be any impact on small businesses as a result of these Regulations.

12. Monitoring & review

12.1 These Regulations are intended to facilitate the transition to risk-reflective-pricing for flood insurance over the course of the FR Scheme's lifetime. There will be regular reviews of the Regulations by the Department, and at least every five years from inception. These reviews will evaluate the extent to which the FR Scheme is achieving its objectives of ensuring the provision of available and affordable flood insurance as part of a managed transition to risk reflective prices and set the FR Scheme's forward looking trajectory over the next five year period. As part of this review, the FR Scheme administrator will put forward recommendations for levels of the levy and reinsurance premium thresholds for the following review period for the Secretary of State to consider (as set out in Regulation 27).

13. Contact

13.1 Matt Whittles at the Department for Environment, Food and Rural Affairs Tel: 020 7238 5204 or email: Matthew.Whittles@defra.gsi.gov.uk, can answer any queries regarding the instrument.