

Flood Insurance in the UK

Morpeth
Flood Action Group



Our Proposal for the Way Forward Version 2.01



Morpeth Group - November 2011



A framework to prevent the community blight that moving to a risk based flood insurance model would cause

In the UK insurance cover against flood damage is part of the package for residential customers. From the early 60's onwards it was made widely available and affordable under the "Gentleman's Agreement" between the insurance industry and the government of the day. In order to meet their commitment to availability at affordable prices the insurance companies that have abided by the agreement have to date supported the properties at high risk of flooding by means of subsidy in the premiums of those at low risk. This cross subsidy has functioned as an act of solidarity on the part of one set of policy holders to another, and companies have spread the risk across their portfolios. While this agreement kept premiums affordable the floods of 2000 brought to a head the problems insurance companies were experiencing with exposure and competitiveness.

In recognition of the growing problems, in 2002 the government and the ABI acted together to introduce the Statement of Principles, an agreement which guaranteed the availability of insurance to high risk properties in return for a government commitment to manage the level of flood risk in the UK. Affordability was not part of the agreement and companies were able to charge premiums that reflected risk more. Because new insurers entering the market avoided properties at high risk of flooding and because of improvements in flood mapping, the cross subsidising of policies was found to be unsustainable in a competitive market. The current Statement of Principles dates from 2008 and terminates in June 2013. Nor has the Statement of Principles served the consumer well, as premiums and excesses increased dramatically for those who had been affected by flooding and those at high risk to the extent that they have become



unaffordable. The consequence of this is that there is a great likelihood of blight setting in to the most vulnerable communities.

Pressure from communities and concerned groups forced the previous government to agree a summit of interested parties to come up with proposals for flood insurance that would include affordability and availability and would be sustainable going forward. The current government convened the summit and its various subgroups continue their deliberations.

We know of two models that have been presented to the summit:

The Morpeth Model which was produced by a consortium consisting of representatives of Morpeth Flood Action Group, Morpeth Town Council and Morpeth Chamber of Trade. Supported by the National Flood Forum it can be downloaded from <http://www.morpethfloodaction.org.uk/html/proposal.html>.

The ABI has made a presentation based on a report they commissioned from Oxera, an outline of which can be downloaded from <http://www.oxera.com/main.aspx?id=9945> That report is still under consideration by the ABI.

THE CONSEQUENCES OF MOVING TO A RISK-DIFFERENTIATING, MUTUALISTIC INSURANCE MODEL

If the government fails to act, the insurance industry will be forced into adopting a model of risk-reflective premiums for those at high risk of flooding. The market is already moving towards this because of the uncertainty of how things are going to develop when the Statement of Principles comes to an end.

- In flood affected communities across the country, evidence is emerging that some insurance companies have revised and continue to revise policy terms for residents and business owners in flood plain areas. Annual premiums have increased and substantial policy excesses are becoming more commonplace. There are signs of insurance blight gradually affecting communities.
- Reluctant to abide by the commitments contained in the Statement of Principles, some insurers have withdrawn cover from householders. Other insurers which adhere to the Statement have increased premiums and excesses. They have done this to reflect the level of risk that flooding represents to them.
- Trawling the price comparison websites reveals that new insurance companies do not offer flood insurance cover for flooded properties and only specialist insurers will consider new business, usually at rates that are unaffordable. In communities across the country it is becoming apparent to residents, business owners and those considering investment in those communities that new flood insurance is no longer available at affordable rates - if it is available at all.
- There is a dilemma here, caused by the natural and conflicting interests of private insurance companies on the one hand and the needs of residents and property owners on the other. This conflict will jeopardise the future prosperity of communities, if it is not resolved.
- The effects of insurance blight would be multiplied, if communities experienced another similar flooding event or worse. They would be unlikely to recover fully a second time. With so many homes and businesses within any given community

subject to high insurance excesses, the owners would be unable to fund the cost of repairs a second time round, leaving their community blighted by derelict properties in the flood affected areas, which may include core areas of their town or village. Existing businesses would move away, unable to survive a further interruption of trade or absorb future risks of flooding following the withdrawal of insurance cover. New businesses would be deterred from entering communities and the related core areas for the same reasons.

- There is evidence that insurance blight continues in Carlisle even though the Environment Agency has completed the construction of 1 in 200 year flood alleviation scheme. Major insurance companies are still refusing to offer new cover in previously flooded areas.

THE MODELS

The original Morpeth Model was written in June 2010 following research into insurance schemes in other countries . The authors concluded that the flood aspect of household insurance should be excluded from the standard package and that a system of universal pooling should be introduced instead. Under that original version of the Model all properties pay a flat rate levy into a pool and all claims for flood damage are settled from the pool, which is administered by the insurance companies. The detailed workings of the Model were held in abeyance pending the acceptance of that principle. The lack of detail means that the August 2010 amended version of the Model does not necessarily stand up to scrutiny. These issues have been addressed by the authors and the results of their deliberations are shown below as the revised Morpeth Model .

Based on research they undertook commissioned by the ABI, Oxera has produced a possible model "that could support the widespread provision of flood insurance by the private sector and be implemented when the existing Statement of Principles expires". This model also supports some form of pooling. However, it differs from the Morpeth Model in that its proposals for pooling involve only the high risk properties and it proposes to introduce a threshold above which policies are ceded to the pool. The model looks for some form of subsidy to help finance the pool, but the source of that subsidy is not determined.

DIFFERENCES AND SIMILARITIES

It is fundamental to both models that there is a pool. Implicit within the original Morpeth Model is that all flood related claims are paid for by the pool. The Oxera Model, on the other hand, eschews universal pooling in favour of a pool reserved exclusively for high risk properties. Claims on high risk policies are settled from that pool and the rest are settled by the insurance companies in a manner that is similar to existing practice.

Both models require an element of subsidy. However, whilst the Morpeth Model provides for the imposition of a Community Flood Levy on all household policies, the Oxera Model needs some form of cross subsidy drawn from the premiums paid by policy holders or alternatively a subsidy funded by government. Since one cannot realistically expect the government to fund any solution to the impending insurance crisis, the Oxera Model subsidy must come from within the industry.

Both models combine affordability with availability. The Oxera Model provides for premiums reflecting the risk in the form of a threshold, a keystone requirement, but there is no such provision in the Morpeth Model.

The Morpeth Model requires the insurance company that holds the policy for the remainder of the bundle to administer any flood claims for that property, drawing on the resources of the pool to cover the costs. The Oxera Model anticipates that claims against low risk policies will be administered by the insurance companies that hold them. No mention is made of how high risk policy claims are to be administered.

A RETHINK OF THE MORPETH MODEL

In the light of new insights gained from the ongoing debate the authors of the Morpeth Model accepted that there was little likelihood of it progressing in its existing form since it did not address key requirements of the summit.

- There was no reflection of risk.
- There was no financial incentive for the policy holder to improve resilience or introduce resistant measures.
- Whilst there was competition for the rest of the policy bundle, competition was removed from flood cover completely.
- There was no pressure on insurance companies to share the risk.

There was no provision reflecting risk in the original Morpeth Model. A fundamental principle of the Morpeth Model, excluding risk was seen as the most appropriate way of preventing community blight. In light of recent developments, however, and following

further research, the authors have come to the conclusion that this principle will have to change.

The Oxera Model demonstrates that there is a growing consensus for pooling as the only way forward. As a next step the revised Morpeth Model has to address the issue of combining some form of risk based premium with the notion of universal pooling. The revision must also address some of the other issues mentioned above.

THE OXERA MODEL

Under the Oxera Model, if the total policy premium (which includes the risk related element for flood damage) exceeds a given threshold, the flood risk element can be ceded entirely to the pool. The elements not related to flood risk then comprise the policy as far as the insurance company's dealings with the householder are concerned. Furthermore it appears to the authors of the Morpeth Model that under the Oxera Model the flood risk element of the premium would be offered at a reduced rate because of the support provided by the subsidy mentioned above – the funding for which, however, has yet to be specified. That would reduce the overall premium.

While it is felt that this model is a step in the right direction there are various issues that raise concern, or need further clarification.

- Whilst low risk policies are administered by the insurance company, it is not clear who takes on the high risk policies. If they are to be administered by a separate entity employed by the pool the costs incurred by that entity could reduce the value of the savings that might otherwise be made.
- Because the threshold is based on cost of reinstatement with no reference to the ability of households to pay, properties could be ceded to the pool purely because of their size and not because of flood risk. This could mean that higher earning households would receive more of a subsidy than those less able to pay.
- There is no explanation of where the subsidy would come from. Government is not likely to provide it. The subsidy will therefore have to be raised from within the industry.
- Although a competitive market is retained there could still be an element of "cherry picking" by some insurance companies as they attempt to reduce premium assessment costs. That could impact on the cost of the risk assessed premium ceded to the pool.
- If those administering the pool decide to employ their own risk assessors there will be additional costs.
- There is a danger that the model could create a two tier market that is not equitable.
- The insurance industry is failing to share the exposure to claims from properties at high risk of flooding.

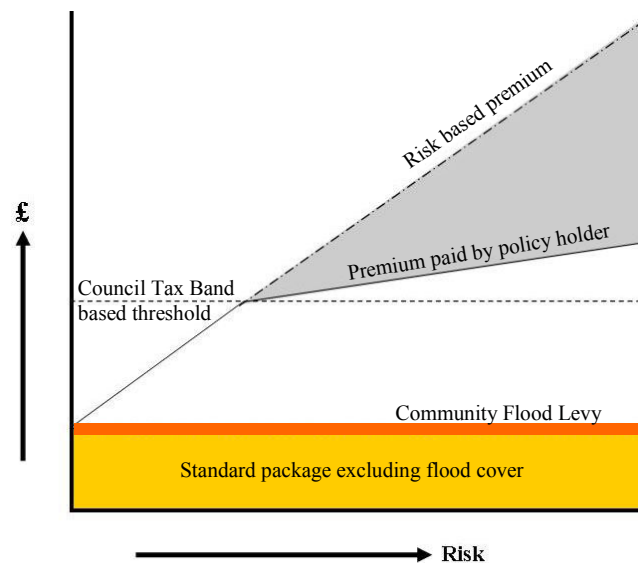
THE REVISED MORPETH MODEL

The revised Morpeth Model combines elements of the Oxera Model with the original principle that affordable flood insurance should be built round subsidy from within the industry. The government would only ever be required to provide funding on a temporary basis - effectively in the form of a loan - if there were major flood events in consecutive years. Any such loan from the government would be repaid from the pool as the amounts ceded to it were adjusted to match the costs of flooding events year on year.

1. A pool would be set up to help cover claims for flood damage to properties at high risk of flooding.
2. There would be a levy on all household insurance policies which would be paid into the pool. In the interest of transparency this would be called the Community Flood Levy. The insurance industry as a whole would decide whether the levy would be charged across the board at a flat rate or as a percentage of the premium.
3. Insurance companies would assess the flood risk portion of the premium in the usual way to produce the risk-related premium.
4. The risk-related premium would be subject to a threshold determined by the Council Tax band of the property (rateable value in Northern Ireland). The proportion of the risk-related premium above this threshold would be used to determine the contribution to the pool.
5. Only a percentage of the risk-related premium above the threshold would be paid into the pool, the shortfall in monies to cover the claims of these higher risk policies being made up from the Community Flood Levy contributions.
6. The premium charged to the policy holder would comprise the amount for the other elements of the package together with the Community Flood Levy, the risk-related premium up to the threshold level and a percentage of the risk-related premium above the threshold.
7. The amount paid into the pool from each policy premium by the insurance company would comprise the Community Flood Levy together with the percentage of risk-related premium above the threshold.
8. Since high excesses do not encourage the installation of resilience and resistance measures, they present an obstacle to

progress. Insurance companies would inevitably compete to find optimum levels for excesses.

9. The insurance industry would be responsible for ensuring that the pool remained solvent and it would therefore determine the amount paid by policy holders under the Community Flood Levy, adjusting that amount in response to unfolding events.
10. The threshold premium and the proportion to be paid into the pool would be determined by the government as part of its responsibility for oversight of the whole process.
11. The pool would be managed and administered by the insurance industry.
12. A flood damage claim would be administered by the insurance company holding the policy. If the flood element of the premium was below the threshold the insuring company would be responsible for covering the full cost of reinstatement. If there was an element of the premium above the threshold level then the insurance company would settle the full amount of the claim but would be able to draw down from the pool the percentage of the risk-related premium to which it was not exposed. As an example, if half of the risk-related premium was above the threshold then the insurance company would have half of the reinstatement costs paid for by the pool. This would ensure that the insurance industry shared the risk.



The revised Morpeth Model provides a possible new market-based model for the provision of flood insurance that is both affordable and available to owners of high risk properties. It significantly reduces the possibility of property blight, and the consequential community blight, that high insurance premiums would bring. It is equitable, practical and deliverable.

As with all proposed models for the future of flood insurance after 2013, it will require some direction from government. The insurance industry cannot be expected to resolve the impending crisis by itself.

The Morpeth Model meets all of the criteria set down by Working Group 1 of the summit.

GOING FORWARD

The Model by itself does not represent a complete solution for flood insurance post 2013. It will form part of a flexible and changing framework which aims to provide a robust and sustainable future for the household insurance market. Issues will include -

- Addressing the problems of building on flood plains by keeping PPS25 in the new National Planning Policy Framework. The definition of sustainable development must include insurability against future flood events and climate change.
- Bringing resilience and resistance into the Building Regulations for England and Wales, a model for this is the Scottish Building Regulations.
- The findings of Working Groups 2 and 3 and implementation of their recommendations.

SETTING THE THRESHOLD

Establishing a threshold that is affordable for each individual household is key to the fairness of the model. If the threshold is too high it will marginalise the most vulnerable, if too low it could distort the market. It would be impractical to introduce means testing, and therefore a simple indicator that largely correlates to ability to pay is required. Property value would provide such an indicator. There will, of course, be anomalies as with any similar simple indicator. The Council Tax band of a property is a simple and readily available indicator of its value. Age of adults and occupancy details will have been collected for other premium assessment requirements so the anomaly of the widowed pensioner living in the large former family home, for example, can be taken into account.

RESILIENCE AND RESISTANCE

Two Working Groups, 1 and 3, are looking into ways of incorporating incentives for householders to install resistance and resilience measures into any future insurance model. Most of the emphasis is on this model

involving risk based premiums in one form or other. It is one of the keystones for the summit that premiums should reflect flood risk.

It is the opinion of the authors, and many others, that there is an overemphasis on resistant products. Insurance companies do not recognise them now, and we can see no reason why they should in the future. Because of the expense of resilience measures the financial incentives available through premium reduction will be insufficient to convince people to introduce them in existing properties which have not already been flooded. Resilience is most efficiently installed after a property has been flooded. Resilient repair can save as much as 80% of the costs of the next flood.

The vulnerable make up a high proportion of residents in high risk flood areas. If premiums are to reflect flood risk it is highly unlikely that those people will be able to afford insurance let alone have the capital available to purchase resistance and resilience for their properties.

Any future insurance model that has an element of solidarity in it will not be able to provide sufficient financial incentive to encourage betterment. Other forms of incentive will have to be found that do not have a detrimental effect on well-being.

NEW DEVELOPMENTS

It is inevitable that builders and planners will pursue development on flood plains and other areas at high risk of flooding. Currently the insurance industry subsidises the developers' profits when they accept the greater exposure entailed in insuring developments on flood plains against flood damage. Developments should not be allowed to proceed if they produce dwellings that will have unaffordable insurance premiums. Good design and construction techniques can reduce vulnerability to flooding. Scotland has Flood Liaison Advice Groups (FLAGs) at a local level to steer developers towards sustainable development. Insurance companies are represented on those FLAGs, it would be a welcome move if a similar approach were to be introduced in England and Wales. The threshold level of the Morpeth Model could be used as a benchmark for sustainable development. For any new build dwelling that would exceed the premium threshold the developer would be required to pay a bond into the pool to cover possible future flood damage. This would encourage robust and sustainable design.

Appendix 1

WELLBEING

An on-going and central concern of the authors of the Morpeth Model is that flood events will lead to community blight if the Statement of Principles no longer holds good, because after 2013 individual households in flooded communities could be left completely without flood insurance.

One factor contributing to community blight will be existing low levels of wellbeing. These will be considerably exacerbated if the people experiencing them find that flood insurance is beyond their reach financially. Stability is essential, yet such will be the fallout from risk related premiums that only some form of cross subsidy of premiums will halt the decline in wellbeing that is bound to ensue.

The current debate has taken an unwelcome turn because commercial concerns have been accorded precedence over the wellbeing of individuals, the tacit assumption being that individuals will have a greater sense of wellbeing simply because flood insurance has been made available, regardless of cost. Anyone drawing that conclusion is guilty of a serious error of judgement.

Whether at the level of the community or the individual household, the installing of resistance and resilience measures can reduce the trauma caused by a flood. They both give people a feeling of being in control of events and also reduce the time spent away from home following a flood. Additionally a speedy reinstatement process helps reduce stress and trauma in flooded households.

Working Group 1 of the summit seeks a solution where financial incentives are offered to policy holders if they install resistance and resilience measures. In the given circumstances, however, the only likely incentive that can be offered is that cover is not granted. This is surely not an incentive at all and will lead only to the further marginalisation of vulnerable groups if it is pursued as a policy. They will simply not be able financially to meet the requirement.

Working Group 3 goes some way towards recognising the urgent need to raise public awareness of the impact of flooding and to establish awareness in the general public's mind of the role of shared responsibility in resolving the issues.

Resistant products can greatly reduce the ingress of flood water and can thus reduce time spent out of the home. In certain circumstances their use can reduce reinstatement costs by up to 80%, but only if a minimal amount of water enters a property. One can reasonably expect policy makers to have gained that insight.

Equally households in communities that have not previously been flooded but are at risk, should be encouraged to install resistance measures, where appropriate. Being aware of the risk in advance is likely to help them deal with the trauma of flooding if it actually happens. Mobilising those communities will prove very difficult, but it has to be done.

Local initiatives that succeed in persuading households to install resistance measure where appropriate will at the same time improve the wellbeing of those communities. Involvement raises self esteem. It is within the remit of the Environment Agency to set this process in motion. A joint approach with the insurance industry and local government, under the direction of central government could raise the self esteem and wellbeing of whole communities.

The use of resilient materials in construction can greatly reduce reinstatement time after a flood. Installing them in new buildings should be a condition before planning permission is granted. Over time that initial additional cost will more than pay for itself in properties at high and severe risk of flooding.

The most appropriate time to install resilience measures in a property is following a flood. Currently this is considered betterment and has to be paid for by the property owner - yet another practice that works to the disadvantage of people on lower incomes. The installing of resilience measures at no additional cost to the householder should become a standard requirement when reinstatement is undertaken. That requirement will install fairness in the process. The whole flooded community will benefit. Levels of wellbeing will be sustained and the most vulnerable members of the community will be safeguarded against the additional trauma that confronting the cost of installing resilience measures brings with it.

Resilience and resistance measures should be installed as a matter of course at the point of reinstatement and at no extra cost to the policy holder. That will help sustain the levels of wellbeing of the whole flooded community, and of its most vulnerable members in particular.

Appendix 2

DISTORTION OF THE MARKET

DOES THE STATEMENT OF PRINCIPLES DISTORT THE MARKET?

Representatives of the insurance industry have argued that the Statement of Principles distorts the property insurance market. Others have responded that the distortion is caused by the fact that the practice of cross subsidising is not applied in a uniform way. Were it to be applied universally, the Statement of Principles could be retained and the market would look very different.

On the other hand there is nothing in the Statement that prevents signatories to it from introducing risk related premiums; many companies are already doing just that.

It could be further argued that the Statement became unsustainable because successive governments failed to commit funds to the building of flood alleviation schemes.

In the context it could also be argued that the arrangement failed to deliver consumer choice.

DISTORTION OF PROPERTY PRICES

Because cross subsidising following the Gentleman's Agreement made it possible for householders to obtain household insurance relatively cheaply, prices of properties at high risk of flooding have been kept artificially high. Removing cross subsidising from the equation could have devastating effects on the owners of those properties and on the economy as a whole. There could be blight in communities at high risk of flooding and that blight could in turn cause distortion in the housing market.

In addition we can already see the potential consequences of the introduction of risk related premiums for property values. Continuing that process will pose a further threat to the financial wellbeing of the very communities that cross subsidising was intended to protect.

THE MORPETH MODEL AND DISTORTION

Barriers to competition lead to distortion in any market and the insurance market is no exception. Under the Morpeth Model insurance companies continue to compete for custom in the usual way until the proposed threshold is reached. Above the threshold they can continue to compete but within a framework where the scope for offering differentiated premiums is reduced. This would at first appear to be a distortion, but if the whole market adheres to the same principles and consumers are freely able to have choice, competition remains.

Comparison websites have demonstrated that, even if the difference between competitive quotes is minimal, consumers are prepared to change insurance companies. If consumers continue to have those choices insurance companies will be deterred from increasing premiums as a means of offsetting their risks.

By comparison the Oxera Model fails to maintain a competitive market for high risk properties because it cedes them to a subsidised pool to produce affordable premiums that standard insurers, as well as specialist ones, will not be able to undercut.

CONSUMER CHOICE

Proceeding from the assumption that competition works against distortion of the market, successive governments have also adhered to the notion that consumer choice drives competition and helps keep prices down. It is therefore clear that owners of properties at high risk of flooding need the benefit of that consumer choice. That choice is available under the Morpeth Model.

If household insurance is to remain affordable across the board, ceding to a high risk pool will produce a two tier system that will not be competitive. That will be one consequence of introducing the Oxera proposals.

The Morpeth Model, on the other hand, sets out proposals which are viable, realistic and equitable.

Appendix 3

The authors

We are a group comprising representatives of Morpeth Town Council, the Morpeth & District Chamber of Trade and the Morpeth Flood Action Group.

We have drawn on our experiences in dealing with the aftermath of a flood which inundated our town on 6 September 2008. Those experiences are typical of so many other communities throughout the country.

Morpeth is the administrative headquarters of Northumberland and is located on the banks of the River Wansbeck 16 miles north of Newcastle upon Tyne.

The flood event in Morpeth

The rain which fell on Morpeth and the catchment area of the River Wansbeck between 4 and 6 September 2008 was unprecedented. An Environment Agency press release stated:

"The flooding experienced by Morpeth was the most severe ever recorded for this location, with more than three times the long-term average rainfall for the whole month - more than 150 millimetres - falling on the town in less than 48 hours. The normal monthly average rainfall is 50 millimetres."

One thousand properties were affected with hundreds of homes and businesses flooded at depths sometimes exceeding 5 feet. Public buildings suffered major damage including the library, the leisure centre, St George's Church, the Chantry, a large local health centre and the local ambulance station.

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