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

2015 No. [XXXX]

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

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

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 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.

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

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 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

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

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 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.

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

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 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

[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

[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

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 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 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

[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

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 Ruth Stubbles at the Department for Environment, Food and Rural Affairs Tel: 020 7238 4666 or email: Ruth.Stubbles@defra.gsi.gov.uk, can answer any queries regarding the instrument.

SCHEME DOCUMENT

Water Act 2014

The Flood Reinsurance (Scheme and Scheme Administrator Designation) Regulations 2015

Issue 1

16 March 2015

Contents

1. Definitions

2. Introduction

3. Description of the FR Scheme

4. Scope of the FR Scheme

5. Funding of the FR Scheme

6. The FR Scheme's role in providing information on flood risk

7. Review and transition

1. **Definitions**

In this document the words and expressions shall have the following meanings:

buildings policy	means a contract of insurance covering the structure of household premises, which may include fixtures and fittings, swimming pools, permanently fixed hot tubs, tennis courts, patios, terraces, service tanks, drains, septic tanks, pipes and cables, central heating fuel storage tanks, driveways, footpaths, garden walls, hedges, gates and fences
combined policy	means a contract of insurance which comprises a buildings policy and a contents policy
consumer prices index	means the all items consumer prices index published by the UK Statistics Authority or, if that index is not published for a relevant month, any substituted index or index figures published by the UK Statistics Authority
contents	in relation to a dwelling, means household goods and personal possessions, which may include valuables (except fine art), clothes, sports equipment and bicycles, camping equipment, money, satellite dishes, aerials and other articles, which belong to persons who live in the dwelling or for which they are responsible, or which belong to guests in the dwelling (except paying guests)
contents policy	means a contract of insurance covering the contents of household premises which consist of a dwelling
contribution	means a sum payable by way of capital contribution by a relevant insurer to the FR Scheme administrator pursuant to a contractual obligation under or by virtue of this Scheme
Designation Regulations	means the Flood Reinsurance (Scheme and Scheme Administrator Designation) Regulations 2015
dwelling	means any building, or part of a building, or mobile home in the United Kingdom that is held for private, residential use as a single residential unit, and includes any garage, shed or other building which forms part of, and is enjoyed with, the residential unit
Financial Conduct Authority Handbook	means the Financial Conduct Authority Handbook published by the Financial Conduct Authority (as amended or replaced from time to time)
financial year	means a period of 12 months ending on the 31st March
flood	means water, from any source external to a building, which enters a building - (a) at or below ground level, or above ground level, provided that part of the body of such water is at ground level; and

	(b) does so with a volume, weight or force which is substantial and abnormal. The following do not constitute a flood: (i) the gradual seepage or percolation of water into a building (such as rising damp); (ii) water escaping from a water main, drain, sewer, pipe or other thing inside a building, unless such escape was solely the consequence of a flood falling within paragraphs (a) and (b)
Flood Re Limited	means, Flood Re Limited a company limited by guarantee registered in England and Wales with company number 08670444, and designated as the FR Scheme administrator pursuant to the Designation Regulations
Flood Risk Element	means any and all: (a) risks of damage, loss and/or liability arising out of or in connection with any flood, (b) exposures to such risks, and (c) damage, loss and/or liability (including claims) arising out of or in connection with such risks and/or exposures, potentially or actually (as matter of fact or law) assumed, faced, incurred or suffered by any person, or otherwise, in respect of household premises and/or contents
FR Scheme administrator	means the body designated as the Flood Re Scheme administrator by the Designation Regulations
FR Scheme	means the scheme designated as the Flood Reinsurance Scheme by the Designation Regulations
FSMA obligation	means any obligation to which the FR Scheme administrator is subject under or by virtue of the Financial Services and Markets Act 2000
gross written premium	a relevant insurer's **"gross written premium"** means the aggregate sterling amount paid or payable by, or on behalf of, holders of home insurance for the relevant risk element of home insurance, before the deduction of any amount (including commission), but after the deduction of insurance premium tax; a relevant insurer's gross written premium must be increased by the amount of any gross written premium paid or payable for the relevant preceding calendar year for "transferred home insurance"; **"transferred home insurance"** means the rights and liabilities arising out of, or in connection with, home insurance, where the home insurance –

	(a) formed the whole, or part, of an insurance business carried on by a person ("A"), (b) the insurance business, or that part, has been transferred to, or has otherwise vested in, the relevant insurer in the preceding calendar year, and (c) A is not a relevant insurer on the date on which the levy is due under regulation 9 of the Regulations. When calculating a relevant insurer's gross written premium, home insurance shall be taken to cover only the relevant risk element unless the contrary is shown by the relevant insurer to the reasonable satisfaction of FR Scheme Administrator; **"the relevant risk element"**, in relation to home insurance, is any risk of damage to, or the loss or destruction of, either or both of the following – (a) a dwelling; (b) the contents of a dwelling
home insurance	has the meaning given to such term in regulation 2 of the Regulations and **sections 4.3** and **4.4** of this Scheme Document
household premises	has the meaning given to such term in regulation 5 of the Regulations and **sections 4.6** to **4.9** of this Scheme Document
inwards reinsurance	means insurance obtained by relevant insurers from the FR Scheme administrator
Liability Limit	has the meaning given to such term in **section 4.10** of this Scheme Document
Member	means a relevant insurer which is a corporate member of Flood Re Limited
mobile home	means a caravan within the meaning of Part 1 of the Caravan Sites and Control of Development Act 1960[8] (disregarding the effect of section 13(2) of the Caravan Sites Act 1968[9]), which is occupied by the occupier as their only or main residence
Non-Member	means a relevant insurer which is not a corporate member of Flood Re Limited
outwards reinsurance	means insurance obtained by the FR Scheme administrator from the market
PRA	means the Prudential Regulation Authority or any successor appointed from time to time
PRA Handbook	means the PRA Handbook and/or Rulebook (as applicable) published by the PRA (as amended or replaced from time to time)

[8] 1960 c.62

[9] 1968 c.52

preceding calendar year	in relation to a financial year, means the year ending on 31st December immediately preceding the financial year
the Regulations	the Flood Reinsurance (Scheme Funding and Administration) Regulations 2015
relevant insurer	an insurer is a relevant insurer in a financial year, if the insurer: (a) (i) effected any home insurance in the period of 12 months immediately preceding the first day of the financial year; and (ii) has permission under the Financial Services and Markets Act 2000[10] which allows the insurer to effect and carry out home insurance on the first day of the financial year; or (b) is a member of the Society (within the meaning of the Lloyd's Act 1982[11]) and, as such a member – (i) effected any home insurance during the period of 12 months immediately preceding the first day of the financial year; and (ii) on the first day of the financial year, intends to effect further home insurance during the financial year. For the purposes of paragraph (b), an insurer who falls within paragraph (b)(i) shall be taken to fall within paragraph (b)(ii) unless the contrary is shown by the insurer to the reasonable satisfaction of the FR Scheme administrator
Scheme Document	means this scheme document
Solvency Capital Requirement *or* **SCR**	shall have the meaning set out in the PRA Handbook
Subordinate Legislation	has the meaning given by section 21 of the Interpretation Act 1978 and, for the purposes of this Scheme Document, shall include the Designation Regulations and the Regulations
Type A payment	(also known as Levy 1) means a payment made or due to be made by a relevant insurer in accordance with section 66(1)(a) of the Water Act and regulations 8 and 9 of the Regulations which shall be a levy
Type B payment	(also known as Levy 2) means a payment made or due to be made by a relevant insurer in accordance with section 66(1)(b) of the Water Act and regulations 10 and 11 and 12 of the Regulations which shall be a levy or a contribution

[10] 2000 c.8.

[11] 1982 c.xiv.

Water Act	means the Water Act 2014

In this Scheme Document, save where the context otherwise requires:

1.1 a reference to a statute or statutory provision shall include a reference:

1.1.1 to that statute or provision as from time to time consolidated, modified, re-enacted or replaced by any statute or statutory provision;

1.1.2 to any repealed statute or statutory provision which it re-enacts (with or without modification); and

1.1.3 any Subordinate Legislation made under the relevant statute;

1.2 words in the singular shall include the plural, and vice versa;

1.3 a reference to a **"person"** includes a reference to a body corporate and to an unincorporated body of persons;

1.4 if a period of time is specified and dates from a given day or the day of an act or event, it shall be calculated exclusive of that day and both time and date shall be determined by reference to that prevailing in the City of London in England at the relevant time; and

1.5 the headings in this Scheme Document are for convenience only and shall not affect the interpretation of any provision of this Scheme Document.

2. Introduction

2.1 The scheme described in this Scheme Document is the FR Scheme, being the scheme referred to in section 64(1) of the Water Act and designated pursuant to the Designation Regulations.

2.2 This Scheme Document describes the FR Scheme and provides a framework within which the FR Scheme administrator will administer the FR Scheme.

2.3 The FR Scheme is a not-for-profit flood reinsurance fund which is run and managed by the insurance industry through the FR Scheme administrator.

2.4 The Water Act provides for the establishment of the FR Scheme[12] which is established for the purpose of providing inwards reinsurance to relevant insurers in respect of such risks arising from a flood as are identified by the FR Scheme in such a way as to:

2.4.1 promote the availability and affordability of flood insurance for household premises while minimising the costs of doing so[13]; and

2.4.2 manage, over the period of operation of the FR Scheme, the transition to risk-reflective pricing of flood insurance for household premises[14].

2.5 The Water Act also provides that the FR Scheme will be administered by a body, such as a company, which will be designated as such by the Secretary of State. This body is the FR Scheme administrator.[15]

2.6 The FR Scheme sits within a legislative framework, in particular:

- Part 4 of the Water Act
- The Regulations
- The Designation Regulations

2.7 The FR Scheme administrator will comply with the relevant statutory and regulatory requirements including the Financial Conduct Authority Handbook and PRA Handbook in so far as they apply to the FR Scheme.

2.8 The FR Scheme administrator will enter into inwards reinsurance arrangements with relevant insurers in order to implement the FR Scheme.

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[12] Section 64, Water Act 2014

[13] Section 64 (2)(a) Water Act 2014

[14] Section 64 (2)(b) Water Act 2014

[15] Section 65, Water Act 2014

2.9 The FR Scheme is designed to operate for up to 25 years from the date of Royal Assent to the Water Act.

3. Description of the Scheme

3.1 Reinsurance is a way for insurers to insure themselves against large scale losses, in this case caused by flood, with other insurers. The FR Scheme is intended to encourage the availability and affordability of insurance for policyholders by helping relevant insurers to reduce the adverse consequences of large claims in relation to flood.

3.2 Under the FR Scheme, relevant insurers will sell home insurance to their policyholders in the usual way, but then may transfer all or some of the Flood Risk Element of such home insurance to the FR Scheme administrator. This means that the Flood Risk Element of such home insurance may be ceded to the FR Scheme administrator via inwards reinsurance arrangements between the relevant insurer and the FR Scheme administrator.

3.3 The insurance policies eligible for the FR Scheme are described in **section 4** of this Scheme Document.

3.4 Relevant insurers may choose to be a Member or a Non-Member. This choice will not affect the ability to cede to or the requirements of ceding Flood Risk Elements to the FR Scheme administrator. If a relevant insurer chooses to be a Member then they will be required to enter into membership arrangements with the FR Scheme administrator and the other Members. Membership will provide the relevant insurer with certain voting rights in relation to the FR Scheme administrator and the possibility of receiving a return of any contributions made to the FR Scheme administrator during the course of being a Member (as described in **sections 5.1.5.3** to **5.1.5.5** (inclusive)). The Secretary of State will be a special corporate member of the FR Scheme administrator with certain limited rights agreed with Flood Re Limited.

3.5 If a policyholder's household premises is flooded, then that policyholder will deal with their insurer in the usual way to get their claim paid. The contractual responsibility for paying out to the policyholder, if a valid claim is made, still rests with the relevant insurer. However, the relevant insurer may then recover claims from the FR Scheme administrator in accordance with the inwards reinsurance arrangements on the Flood Risk Element of insurance policies ceded to the FR Scheme.

3.6 The FR Scheme administrator's liability as reinsurer will be circumscribed, both in terms of the operation of the reinsurance and the attributes of risks (properties and policies) that may be ceded to it and which could give rise to payable claims. These aspects are covered in **section 4** of this Scheme Document.

3.7 The funding for the FR Scheme is described in **section 5** of this Scheme Document.

3.8 Within the context of the purpose of the FR Scheme, the FR Scheme administrator will (in particular), have regard to the following in discharging its functions:

3.8.1 the need to ensure economy, efficiency and effectiveness in the discharge of those functions;

3.8.2 the need to act in the public interest; and

3.8.3 the need to ensure propriety and regularity in the operation of the FR Scheme.[16]

3.9 The FR Scheme administrator will designate the person who acts as its Chief Executive Officer as the "Responsible Officer" of the FR Scheme. [17] The Responsible Officer has the following specific responsibilities in relation to the FR Scheme:

3.9.1 accountability to Parliament for the stewardship of the FR Scheme, including management of its finances;

3.9.2 accountability to Parliament for the economy, efficiency and effectiveness with which the FR Scheme administrator uses resources in discharging its functions under the FR Scheme;

3.9.3 accountability to Parliament for propriety and regularity in the operation of the FR Scheme;

3.9.4 accountability to Parliament in respect of any reports laid under regulation 24 of the Regulations; and

3.9.5 the laying of a copy of the audited accounts of the FR Scheme and the annual report of its auditor before the House of Commons, no later than 3 (three) months after the end of the financial year to which those accounts and annual report apply[18].

3.10 The FR Scheme administrator will also have regard to the need to manage the transition to risk-reflective pricing of flood insurance for household premises[19]. This process is described in **section 7** of this Scheme Document.

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[16] Section 20, The Flood Reinsurance Scheme (Funding and Administration) Regulations 2015

[17] Section 23, The Flood Reinsurance Scheme (Funding and Administration) Regulations 2015

[18] Section 23, The Flood Reinsurance Scheme (Funding and Administration) Regulations 2015

[19] Section 22, The Flood Reinsurance Scheme (Funding and Administration) Regulations 2015

4. Scope of the FR Scheme

General

4.1 Relevant insurers will be permitted to cede the Flood Risk Element of a buildings policy, contents policy or combined policy for household premises to the FR Scheme administrator, by entering into inwards reinsurance arrangements with the FR Scheme administrator and paying the appropriate premium.

Definition of "home insurance" and "household premises"

4.2 The Regulations require the Scheme Document to set out certain criteria relating to the definitions of "home insurance" and "household premises". These relate to the scope of the FR Scheme in terms of the liability of relevant insurers to pay levies and what insurance policies may be ceded to the FR Scheme administrator. These criteria are set out below in **sections 4.3** to **4.9**.

Liability of relevant insurers to pay levies and/or contributions

The Regulations require relevant insurers to pay levies and/or contributions for home insurance policies which they underwrite.

4.3 **"home insurance"** means a contract of insurance which:

4.3.1 includes cover for any risk of damage to, or loss or destruction of, either or both:

4.3.1.1 a dwelling; or

4.3.1.2 the contents of a dwelling; and

4.3.2 meets the criteria set out in **section 4.4** below.

4.4 This **section 4.4** sets out the criteria for **"home insurance"** in accordance with regulation 2 of the Regulations:

4.4.1 The insurance contract must cover the contents of a dwelling and/or the structure of a dwelling which may include fixtures and fittings, swimming pools, permanently fixed hot tubs, tennis courts, patios, terraces, service tanks, drains, septic tanks, pipes and cables, central heating fuel storage tanks, driveways, footpaths, garden walls, hedges, gates and fences.

4.4.2 The insurance contract must be held in the name of, or on trust for, one or more individuals or by the personal representative of an individual.

4.4.3 The dwelling or its contents must be insured on an individual basis.

4.4.4 The individual (or one of the individuals) referred to in Section 4.4.2, above, or their immediate family, must live in the dwelling for some or all of the time (whether or not with others) or the dwelling must be unoccupied.

Eligibility to cede

4.5 Only the Flood Risk Element of a combined policy, a buildings policy or a contents policy for **"household premises"** is eligible for re-insurance under the FR Scheme.

Acceptance of household premises for inwards reinsurance by the FR Scheme administrator will be subject to conditions in the inwards reinsurance arrangements between the relevant insurer and the FR Scheme administrator.

4.6 **"household premises"** means:

4.6.1 a dwelling; or

4.6.2 a building in the United Kingdom[20] which is held for private residential use and comprises two or three residential units, and includes any garage, shed or other building which forms part of, and is enjoyed with, the building,

which (in either case) meets the criteria set out in **sections 4.7 to 4.9** below.

4.7 This **section 4.7** together with **sections 4.8** and **4.9** set out the criteria for **"household premises"** in accordance with regulation 5 of the Regulations:

4.7.1 In the case of a dwelling:

4.7.1.1 if it is in England, it must be in valuation band A to H for Council Tax as set out in section 5(2) of the Local Government Finance Act 1992;

4.7.1.2 if it is in Wales, it must be in valuation band A to I for Council Tax as set out in section 5(3) of the Local Government Finance Act 1992;

4.7.1.3 if it is in Scotland, it must be in valuation band A to H for Council Tax as set out in section 74(2) of the Local Government Finance Act 1992;

[20] Excluding Isle of Man and Channel Islands.

4.7.1.4 if it is in Northern Ireland, it must have a value as at 1st January 2005 as set out in the Rates (Capital Values, etc.) (Northern Ireland) Order 2006; and

4.7.1.5 it must have been added to the Council Tax Valuation list (or equivalent) or been constructed (as determined by such list) before 1 January 2009.

4.7.2 In the case of a building falling within **section 4.6.2** of the definition of **"household premises"** (above), each of the residential units:

4.7.2.1 if it is in England, must fall within **section 4.7.1.1**;

4.7.2.2 if it is in Wales, must fall within **section 4.7.1.2**;

4.7.2.3 if it is in Scotland, must fall within **section 4.7.1.3**;

4.7.2.4 if it is in Northern Ireland, must fall within **section 4.7.1.4**; and

4.7.2.5 must have been added to the Council Tax Valuation list (or equivalent) or been constructed (as determined by such list) before 1 January 2009.

4.8 The **"household premises"** must also be covered by a contract of insurance which:

4.8.1 includes cover for any risk of damage to, or loss or destruction of, either or both –

4.8.1.1 the household premises; or

4.8.1.2 the contents of the household premises which consists of a dwelling; and

4.8.2 meets the following criteria set out in **section 4.9**.

4.9 The criteria mentioned in **section 4.8.2** are:

4.9.1 The insurance contract must be held in the name of, or on trust for, one or more individuals or by the personal representative of an individual.

4.9.2 The household premises or its contents must be insured on an individual basis.

4.9.3 The insurance contract must cover the contents of household premises and/or insurance falling within criterion provided in **section 4.9.4** or **section 4.9.5**.

4.9.4 If the insurance contract is a buildings policy or a combined policy which (in either case) covers a dwelling:

4.9.4.1 the dwelling is held on a freehold basis or is a commonhold unit for the purposes of Part I of the Commonhold and Leasehold Reform Act 2002 or is a flat in a tenement for the purposes of the Tenements (Scotland) Act 2004 or, if the dwelling is held on a leasehold basis, the leaseholder insures the structure of the dwelling, and

4.9.4.2 the individual (or one of the individuals) referred to in **section 4.4.2** or their immediate family, must live in the dwelling for all or some of the time (whether or not with others) or the dwelling must be unoccupied.

4.9.5 If the insurance contract is a buildings policy or a combined policy, which (in either case) covers household premises which fall within **section 4.6.2** of the definition of **"household premises"**, the household premises are held on a freehold basis and are insured by the freeholder or by an owner of a share of the freehold who lives, for all or some of the time (whether or not with others), in one of the residential units.

Liability Limit

4.10 The FR Scheme administrator's liability to relevant insurers is capped at an annual aggregate loss amount which will be set in pounds sterling and communicated to the Secretary of State by Flood Re Limited's Chief Executive Officer prior to the coming into force of the Regulations, and will be incorporated by reference as part of the FR Scheme (the **"Liability Limit"**).

4.11 The Liability Limit will be calculated using computer modelling techniques to produce a forecast of the number of policies that will be ceded to the FR Scheme; their level of risk (based on the frequency and costs of historical flood events); and a prudent addition to allow for a margin of error and uncertainty in the forecasts. The Liability Limit will be set with consideration to paragraph 7b of the Memorandum of Understanding from June 2013 agreed between Government and the Association of British Insurers.

4.12 For each financial year, the amount of the Liability Limit will be adjusted for the percentage increase or decrease in the consumer prices index for the immediately preceding calendar year. Subject to these adjustments, the Liability

Limit will be set for an initial period of 5 (five) years and will be kept under review by the FR Scheme administrator throughout this period to ensure that it continues to reflect the parameters described in **section 4.11**. Any changes to the Liability Limit will be effected through a review that will take place in accordance with regulation 27 of the Regulations.

4.13 Should claims on the FR Scheme administrator exceed the Liability Limit, then relevant insurers will continue to be liable to policyholders in accordance with the terms of the insurance policy sold. The FR Scheme administrator will only be proportionally liable to relevant insurers in accordance with the terms of the inwards reinsurance arrangements.

5. Funding

Sources of funding

5.1 The FR Scheme will be funded through a number of sources. These are:

5.1.1 Inwards reinsurance premium associated with ceded policies.

The FR Scheme administrator will charge relevant insurers for inwards reinsurance premiums in respect of the Flood Risk Element of a combined policy, a buildings policy or a contents policy, no more than the amount specified in the Schedule to the Regulations for each such policy corresponding with the relevant valuation band as defined by regulations 15, 16 and 18 or the relevant Flood Re category as defined by regulations 17 and 18 of the Regulations.

The reinsurance premium thresholds will be adjusted each year, in line with the change in value of the consumer prices index in accordance with the Regulations.

5.1.2 A levy which is required to be paid by all relevant insurers in accordance with section 66(1)(a) of the Water Act and regulation 8 of the Regulations (a **"Type A payment"**). This is also known as "Levy 1".

The aggregate amount of Type A Payments payable by all relevant insurers is set by the Regulations. This is subject to any modifications which may be made by amending regulations.

5.1.3 Earnings on investments made by the FR Scheme administrator.

5.1.4 Recoveries from outwards reinsurance.

5.1.5 Any further payments to be paid by all relevant insurers in accordance with section 66(1)(b) of the Water Act and regulations 10 and 11 of the Regulations (a **"Type B payment"**). This is also known as "Levy 2".

5.1.5.1 Type B payments may be paid either as:

(a) a levy by relevant insurers; or

(b) a contribution by relevant insurers who are Members, if so requested by the FR Scheme administrator and so paid by the relevant insurer.

5.1.5.2 The total additional amount requested from all relevant insurers at any one time (in respect of Type B payments) must not be more than the amount that the FR Scheme

administrator considers appropriate for the prudent management of the FR Scheme or where the request is in compliance, or in order for the FR Scheme administrator to comply, with any FSMA obligation or any obligation arising from directly applicable EU legislation, in line with Regulation 11(1)(a)(i).

5.1.5.3 Type B payments made as contributions may be returned to the Members through a distribution by the FR Scheme administrator either (a) during the period of operation of the FR Scheme or (b) at or around the time of winding up of the FR Scheme administrator.

5.1.5.4 A distribution pursuant to **section 5.1.5.3** is subject to:

(a) approval of the board of directors of the FR Scheme administrator;

(b) approval by the PRA; and

(c) the FR Scheme administrator having sufficient capital to exceed its SCR by such amount as the board of directors of the FR Scheme administrator shall (at their sole discretion, subject to any relevant rules) determine is obligatory, necessary or prudent, or otherwise expedient or appropriate following such return of contribution, and provided always that no return of a contribution shall be made prior to the fifth anniversary of the date of such contribution.

5.1.5.5 The FR Scheme administrator shall have no obligation to make any distribution pursuant to **section 5.1.5.3**.

Calculation of the levies and contributions

5.2 Levies and contributions are payable based on each relevant insurer's **"gross written premium".**

5.3 The levy payments and contributions required by the FR Scheme administrator shall be calculated as follows:

5.3.1 Each relevant insurer will pay a proportion of the total amount of the Type A payment and any Type B payment in accordance with that insurer's market share.

5.3.2 The calculation of the relevant insurer's market share will be in accordance with regulations 8(1) to 8(4) and regulations 11(1) and 11(2) of the Regulations.

5.4 In order to calculate the levies and contributions, relevant insurers will be required to provide to the FR Scheme administrator:

5.4.1 such information as may be requested by the FR Scheme administrator in relation to their gross written premium; and

5.4.2 any other information necessary to calculate the levies and contributions as may be requested by the FR Scheme administrator.

The FR Scheme administrator will provide details to each relevant insurer about the type, format, timing and method of delivery of such information, which will be determined by the FR Scheme administrator and notified to the relevant insurers not less than 30 days before such information is required unless the FR Scheme administrator reasonably requires a shorter notice period for the calculation of Type B payments.

Payment of the levies and contributions

5.5 Once the amount of a Type A payment is ascertained by the FR Scheme administrator, it will notify the relevant insurers of the amount due to be paid to the FR Scheme administrator as a levy and the due date (or dates) for payment.

5.6 Once the amount of a Type B payment is ascertained by the FR Scheme administrator, it will notify the relevant insurers of the amount due to be paid to the FR Scheme administrator in contributions or as a levy and the due date (or dates) for payment.

5.7 A relevant insurer must make a Type A payment or Type B payment when and in the amount requested. The FR Scheme administrator will establish a process for the review and adjustment of Type A payments and Type B payments as well as a procedure for the resolution of disputes regarding Type A payments and Type B payments between relevant insurers and the FR Scheme administrator. Any review process and dispute resolution procedure will be available to both Members and Non Members.

5.8 For the avoidance of any doubt, a Type A payment or a Type B payment must be made notwithstanding the possibility that following any review process or dispute resolution procedure, the amount of the Type A payment or Type B payment may be adjusted by reimbursement of any overpayment to the relevant insurer.

Excesses

5.9 The FR Scheme administrator will consult with the Secretary of State on any changes to the excesses on reinsurance to be charged by the FR Scheme administrator. Excesses will be reviewed at least every 5 (five) years.

6.

6 The Scheme's role in providing information on flood risk

6.1 By 1st April of each year the FR Scheme administrator will provide the following information to relevant insurers who have in the immediately preceding financial year ceded insurance policies to the FR Scheme administrator under the FR Scheme (in accordance with the Regulations), so that a relevant insurer may supply that information to holders of those policies:

6.1.1 information about how to find out about the levels of flood risk in the area in which household premises are situated and general information about how to find out about how any flood risk may be managed;

6.1.2 general information about the FR Scheme; and

6.1.3 general information about the estimated impact of the transition referred to in regulation 22(1) of the Regulations on the cost of those insurance policies.[21]

6.2 Where the provision of the above information results in the transfer of personal data to a relevant insurer (at the discretion of the FR Scheme administrator), such transfer of personal data may be subject to data sharing arrangements between the FR Scheme administrator and the relevant insurer.

[21] regulations 26 of the Regulations

7. Review and transition

7.1 The FR Scheme is designed to operate for up to 25 years from the date of Royal Assent to the Water Act.

7.2 The FR Scheme administrator will have regard to the need to help manage the transition to risk-reflective pricing of flood insurance for household premises. The transition plan is intended to address the phasing out of the benefits of the FR Scheme over its lifetime.

7.3 The FR Scheme administrator will produce a plan relating to the management of this transition to risk-reflective pricing of such flood insurance.

7.4 The FR Scheme administrator will publish this transition plan on its website, within 3 (three) months of the coming into force of the Regulations, setting out how this will be achieved.

7.5 The transition plan will contain information about the steps that may be taken to manage the transition to risk-reflective prices for flood insurance and general information about the estimated impact this might have on the amount of the Type A payments and Type B payments required and the level it sets for inwards reinsurance premiums for policies ceded to the FR Scheme administrator.

7.6 The FR Scheme administrator will update the transition plan at least every 5 (five) years, to ensure that the industry and public have access to accurate information about how the price of flood insurance and benefits given by the FR Scheme administrator might change over the 25 year period.

7.7 Should the board of directors consider the voluntary winding up of Flood Re, the FR Scheme administrator will consult with the Secretary of State. In the event of wind-up, the FR Scheme administrator will consult the Secretary of State before any return of contributions is made to Members in accordance with **sections 5.1.5.3** to **5.1.5.5** (inclusive) of this Scheme Document. Such a return will be without prejudice to any regulations the Secretary of State may introduce pursuant to the Water Act.