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MANAGING PARADOX MINI-CASE SERIES

Living the paradox of protection: The case of Flood Re

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THE CASE

The purpose of insurance is to protect individuals or organisations against financial losses that are caused by a pre-agreed event (such as fire, flooding, or illness). Insurance and reinsurance firms can offer such protection because they operate at a scale that allows them to pool the risk; that is, they collect premiums from the many that can be used to pay for the losses of the few. While this model generally works well where insurance firms can distribute the risk, insurers, in order to meet solvency requirements, engage in 'risk-reflective pricing'. This means that the price of a premium should reflect the risk of losses. When events become severe and frequent, such as with repeated flooding, insurance premiums may become unaffordable for policyholders at high risk of flood, due to risk-reflective pricing. For example, in the UK, houses that are located in areas that have been flooded multiple times face rising insurance premiums that makes insurance unaffordable for homeowners. This results in an 'insurance protection gap' in which people who are highly exposed to a particular risk cannot afford to get insurance to pay for their losses (Jarzabkowski et al., 2018; 2019).

In order to address this protection gap, the UK government and the insurance industry established Flood Re, a Protection Gap Entity[1] (Jarzabkowski et al., 2018). Flood Re is a not-for-profit reinsurance scheme with the aim to make home insurance more affordable and available for those in particularly flood prone areas. Through a levy that was legislated by the UK government, the scheme raises £180m each year from insurers, which it uses to cross-subsidise insurance to those at high risk of flood. On the one hand, this solved the problem of unaffordable insurance for those policyholders in flood-risk areas. On the other hand, it meant pricing was no longer risk-reflective. Those policyholders covered by the Flood Re subsidy were not paying a premium that reflected their risk of loss. Concerned not to generate a situation where those at high risk of loss

[1] "the entity that brings together different market and non-market stakeholders in an effort to address the protection gap by transforming uninsured risk into insurance-based products that can be transferred onto government balance sheets or into global financial markets in order to provide capital for recovery following a disaster" (Jarzabkowski et al., 2018, p. 36).

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became free-riders on the rest of society, Flood Re was established with a paradoxical remit. It was to provide subsidies for a period of 25 years, at the end of which it will be dissolved. Flood Re was tasked with leading activities to help the market transition back to risk-reflective pricing. This seemed impossible, since the reason that Flood Re had been developed was because risk-reflective pricing made premiums unaffordable to some policyholders. How could a mission that embraced 25 years of subsidising those at high risk, followed by a return to risk-reflective pricing, solve the problem of unaffordable premiums for those at high risk? Managers at Flood Re, committed to both addressing unaffordability, and also to dissolving their operation within 25 years, considered how to resolve this paradox:

> *What we started with [was to try to] enable availability and affordability. That's what we started to do in the first period. And then, as an equally important objective to managing over [Flood Re's] lifetime the affordability [of insurance] is to transition effectively to risk-reflective pricing. What we're trying to highlight here actually is that risk-reflective pricing isn't going to be met by just upping prices. That's not the intent. It's got to be by reducing average cost of claims and that's what [Flood Re] got to do. (Senior Manager)*

This quote indicates that purely increasing premiums for purchasing home insurance was not going to solve the problem of unaffordability in the long-term. Instead, the planned transition to risk-reflective pricing meant that the future state of these properties had to be incorporated in the present solutions. It would be necessary to provide both affordable home insurance in flood-prone areas and also ensure that risk-reflective pricing in these areas could feasibly be returned to the market and Flood Re dissolved in the future. As a consequence, the nature of the risk had to be changed. This was done via two vehicles. Firstly, Flood Re developed a paradoxical term of 'affordable risk-reflective pricing' to encapsulate both parts of their remit. This would set the tone for developing adequate solutions without giving preference to one or the other. Secondly, Flood Re incorporated into its remit measures to increase "the overall flood

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resistance and resilience of the UK’s housing stock” (Flood Re, 2018, p. 9). They would encourage and support insurers of those in flooded properties to ‘build back better’, meaning that properties that had been affected by flooding would be repaired in a more flood resilient way.

> *If we just cared about transition to risk-reflective pricing, all we would do is spend the increased premiums and reduce the levy and save for our statutory purpose. Because what we've done is given the right signals to the market. We don't just want to do that. [Instead], we want to get to affordable risk-reflective pricing. Then that means we have fewer policies in Flood Re, not because we’re reducing premiums, [but] because the underlying risk is being managed better (Senior Manager)*

While it is still a long way until Flood Re’s planned exit in 2039, Flood Re managers have taken steps to ensure their mission to “create an affordable risk reflective market” (Flood Re, 2018, p. 7). In doing so they have transcended the initial paradox of the Flood Re mission, enabling them to work towards a future scenario of affordable insurance for properties that will be more resilient to flood.

The case of Flood Re raises a number of interesting questions:

- What do you think about subsidies across the collective set of policyholders as a means of addressing unaffordable insurance for some individuals at high risk of loss?
- In what other ways can the tensions of risk-reflective pricing and affordability be addressed?
- Do you see any longer-term problems or paradoxes that Flood Re might need to address arising from their notion of affordable risk-reflective pricing?

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TEACHING NOTE

The case offers an opportunity to see how actors reframe the meaning of their mission, shifting it from paradoxical elements that are in opposition to each other, to a mission that combines both elements. This reframing enables them to transcend the paradox of adhering to risk-reflective pricing whilst also providing affordable insurance for homeowners in flood-prone areas. Of course, there is no single best way to surmount the paradox. Students could consider other avenues for surmounting or living with the paradox.

Areas:
Risk; insurance

Keywords:
Flood Re, risk-reflective pricing; multi-stakeholder

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