CENTRE FOR CLIMATE CHANGE ECONOMICS AND POLICY

Policy Brief

Should Flood Re be extended to SMEs?

Flood Re is a governmental scheme which, among other things, guarantees insurance affordability and encourages self-protection. Small and medium enterprises (SMEs) are vital for local economies; their survival is one of the holy grails of economic recovery when flooding impacts communities. Nonetheless, SMEs remain being the least prepared in times of crisis, as well as understudied and overlooked in flood resilience efforts. This is especially true in terms of insurance protection where they have been excluded from Flood Re. A new study from the UK flood affected areas looks at the economic costs of flooding on SMEs and proposes ways to increase their flood protection.

Centre for Climate Change Economics and Policy

UNIVERSITY OF LEEDS

Sustainability Research Institute
SCHOOL OF EARTH AND ENVIRONMENT

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

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Highlights

A unified flood risk management framework for SMEs is urgently needed, because the negative effects of flooding on SMEs affect entire towns located in flood-risk areas.

Size and turnover should be taken into account when assessing the economic losses of flooding on SMEs and insurance affordability to better understand the extent of the issue.

More needs to be done to fill-in the gap in the understanding the economic costs of SMEs and the effectiveness of property flood resilience and resistance measures to offer affordable and suitable insurance products in flood-risk areas.

Flood Re should not be extended to SMEs but rather a new join partnership from the Government and the industry should be established for towns at flood risk.

Introduction

Flood risk is one of the main climate risks for the UK. A resilient nation needs resilient households and resilient businesses. Flooding is rarely good business, and for SMEs it is sometimes a matter of survival. SMEs are the backbone of cities, towns and communities. They represent 99.3% of all private sector in the UK. Affectations in SMEs have knock-on effects in unemployment, tax revenues, disruptions in the supply chain, growth and prosperity of communities. The UK Climate Change Risk Assessment (2016) has highlighted the urgency to investigate how businesses respond to climate risks and hich opportunities they have to manage impacts like flooding.

This research offers insights from SMEs, insurers, national and local government officials, academics, charities and organisations that support flood prevention and alleviation efforts. The findings provide new evidence of the challenges that SMEs face around insurance, as well as the strategies that SMEs employ to manage flooding and the opportunities that can be made available to them to increase their resilience. The findings are based on data from 39 interviews, 319 SMEs and a reaction workshop. Results show the need for a flood policy framework specifically for this backbone of society.

This policy brief has been written by
Dr. Paola Sakai. It summarises the results of a project and a call for evidence available at CCCEP.

P.H.M.D.Oca@leeds.ac.uk

Relative Economic Costs to SMEs

Small businesses are not small versions of big businesses. Current approaches to assess damages on small firms take into account average economic costs, leaving behind differences related to the size of the business. When identifying which size of firm has the biggest losses, it is normally stated that the bigger the business, the bigger the economic losses. However, opposite results emerged when the number of employees and the annual turnover is considered. This research shows that businesses with less than 5 employees experienced the highest economic losses. The economic losses of a single flood event represented 423% more of what they earn in one month. To put it differently, for every £1 of losses, the monthly sales of a business this size would only cover £0.25, meaning that it will take around 4 months of saving its entire monthly sales to cover the losses due to the flood. For businesses with 5-9 employees, the loss relative to the turnover was 119%. The losses of firms with 10 to 19 employees had a relative economic cost of 66% of their monthly turnover. In this manner, the smaller the business, the bigger the losses. It is crucial to consider the relative costs when assessing SMEs economic costs.

Type of costs and risk management strategies also varies with size

The size of the business also offers insights on where the economic costs are higher. For bigger businesses, the most important thing is to secure equipment. For the smaller, structural damage to their premises represents the highes losses. Consequently, investing in certain property resistance/resilience measures can contribute to minimise the losses. This knowledge can be useful to target interventions that are more fruitful, particularly because the size of the firm also determines the different strategies SMEs take to manage their flood risk. The smaller firms (0-4 employees) normally monitor early warning systems, secure equipment, and move stock and important information. However, they are less likely to talk to suppliers or customers to rearrange deliveries. Bigger businesses are more likely to have a flood risk plan or have undertaken property resilient measures than smaller businesses.

Double impacts: Home-based businesses and landlords-tenants

We found that there are double impacts which are often ignored when assessing the impact of flooding on SMEs. On the one hand, home-based businesses experience higher impacts as a flood event has negative economic consequences, not only on the livelihood of the business owner, but also on their personal life (e.g. a bed and breakfast might not be able to accommodate guests, and the owner might be left without a place to live). On the other hand, renting premises can also have a double economic impact. If the premises are flooded, there will be an economic repercussion to the SME that rents, in addition to an impact to the landlord's income (e.g. cover repairs, deal with unpaid rents, ending contracts early).

There should be more clarity in tenancy agreements regarding flood risk management responsibilities. Moreover, since the majority of the businesses rent their premises, landlords should be encouraged to invest in property resilience measures.

What will happen to towns if businesses start leaving because of constant flooding?

This research explored the scenario of losing businesses as a result of flooding, finding that it can have significant impacts on local economies in the short- to long-terms. If SMEs move away, there are risks that need to be taken into account: loss of a town's attractiveness and character, erosion of the customer base, less variety and diversity of economic activities, increase in undesirable activities linked to more redundant buildings, impact on local budgets (reduction of tax revenues and increases in unemployment claims), disruptions of supply chains, families moving out in search of employment. There is a need to open up spaces and start more profound discussions in order to elicit opportunities to reinvent areas at flood risk. If the objective is to make areas at flood risk climate-resilient and vibrant, then efforts need to be directed now to start building that future. On the contrary, if the objective is to stop people living in flood plains, and encourage SMEs to move away, then there are hard conversations and decisions that need to happen today among the national and local governments, including the people living in flood risk areas.

SMEs and insurance as a widespread issue

There is still uncertainty about whether insurance affordability and accessibility are a widespread problem for SMEs. Results show that in flood risk areas SMEs reported having problems of affordability (high excess or premiums), availability (in the past/future), speed of payment, lack of understanding about what the policy covers, and resilience measures not considered in the pricing. Interviews revealed that it is likely that the problems are localised, thus the problem should be looked relative to the town, rather than to the entire country. Even though the numbers seem small (c. 75,000 in the UK, 1.27% of all SMEs), this number becomes significant to towns at flood risk. For instance, in 2016, around 1,600 businesses were impacted in Calderdale. That number is small if we consider the amount of SMEs in the country. However, to Calderdale, it represented 20% of its entire business sector. The economic costs amounted to £47 million pounds, while the wider costs to the regional economy increased to £170 million pounds. In this sense, the negative repercussions of this "small" number of SMEs were significant for the region. If the problem is localised, then efforts need to be focused on those areas

Market failures

There is a market failure in terms of imperfect information that insurers have on SMEs. Despite efforts made, insurers still do not understand the risk that SMEs represent to them, given that SMEs are very diverse and difficult to commoditise. Uncertainty translates into high risk, which is reflected in the prices and availability of insurance. Results show that the industry is trying to work with SMEs in high-risk areas. Strategies, such as increasing premiums/excess, or re-insuring the excess, have helped the industry to manage their risk exposure and offer in some cases better prices. Nonetheless, there are still questions regarding the affordability of those schemes and whether they work just for a few SMEs or if is a widespread effort of the industry. More needs to be done, in this sense, to understand the risks and the specific needs of SMEs as a first step to be able to offer suitable products and increase the uptake of flood insurance.

Affordability of insurance and benefits of having insurance

When the prices of insurance are analysed in relative terms (considering the number of employees and their turnover), it is clear that the price is considerable for the smallest firms. SMEs with 0-4 employees had to pay around 170% of their monthly turnover. On average, their insurance costs are around £6,000 and their turnover is along those lines, so they would need to save almost an entire month's sales to buy insurance (without considering the costs to run the business). However, when SMEs experience a flood event the economic costs are significant, in the study, the average losses were £24,000, so they would need to save almost 4 months of their turnover to cover the economic costs. In this sense, having insurance makes sense from a societal perspective. But affordability needs to be considered in relative terms, and there is a need to support the smallest SMEs to get affordable insurance. The unaffordability of insurance reported by some SMEs was £7,576 on average.
Insurance, however, should not be taken as the first line of defence, but rather as a measure of last resort. SMEs need to protect themselves, and insurance could be a driver for self-protection if it is tied to the take-up of property resistance/resilience measures (PFR), like the updated 2019 Flood Re, and this is reflected in the price or conditions of insurance. SMEs not only would appreciate being recognised for their efforts, but would also be encouraged to adopt property resilience measures. Nonetheless, this demands a better understanding of the economic costs of flooding on SMEs, the effectiveness of PFR measures that can be put in place, as well as the implementation of coordinated standards, certification and accreditation schemes to trust that the PFR measures will reduce the flood risk.

Should Flood Re be extended to SMEs?

There is a genuine need to offer better and affordable insurance products to SMEs in flood-risk areas. But the answer to the question "should Flood Re be extended to SMEs?" Is no. This would not be easy or even desirable, as Flood Re was designed for households. There are major barriers to extend Flood Re to SMEs, including political, commercial, social, and technical factors. However, ensuring the affordability and accessibility of insurance is particularly important in flood risk areas as it not only protects an SME, but also can un-lock loans and investments. If SMEs are in flood-risk areas and want a loan to buy machinery, for example, they will be required to have flood insurance. If lending processes depend on having in place flood insurance, lenders could also incentivise protection. Thus, encouraging the take-up of insurance could make SMEs more resilient, while unlocking growth and investments in flood risk areas. Creating a new Flood Re scheme that enables and prepares SMEs for a future of affordable insurance, where the government and the UK insurance industry join efforts to support and incentivise community resilience might not be the answer to all SMEs, if the political will and the industry appetite are not there. Explorations could be made perhaps, to include some type of SMEs, such as home-based businesses, the smallest SMEs and landlords. This research showed the importance of looking at the relative size of the firm, so, the number of employees and the turnover could serve as a proxy to determine affordability of insurance (like Council tax bands are for households).

Making flood insurance compulsory to SMEs in flood risk areas?

Exploring this question was an interesting exercise. As one of the interviewees expressed: "*If we drive a car, you have a car insurance. Why, if you live in a flood zone… should you not have flood insurance? I don't get it*". Even if the business is at the top of the hill of a town that is at flood risk, it is part of the town and it benefits from the vibrancy of the town. There is a need to look at towns at flood risk as one system because if SMEs are protected, it will help the risk management of entire towns, as well as the wider supply chains, and businesses that rent their premises. However, if insurance was made mandatory, it would not be fair if affordability issues are not resolved. There should be a comprehensive flood risk management framework where SMEs are encouraged to increase their uptake of PFR measures. It is acknowledged that its implementation would be complex and there might be resistance to change, but this could be explored.

Community self-organisation and moral hazard

Self-organisation has been one of the mechanisms that SMEs and their communities can use to overcome flooding impacts. There are examples of businesses and communities coming together to cope with a flooding event and to prevent future impacts. However, self-organisation only happens when there is a strong sense of community, trust, and the social-business networks are already developed. There is a need to enable spaces where businesses can come together to share experiences. There is also the need to help business-community-led initiatives to embed flood resilience as a priority.

A cultural shift towards transferring ownership of risks and giving responsibilities to communities is starting to happen, but more coherence is needed. It is essential to have a common understanding that, while the government does have a role to play in managing flood risks, every member of the community needs to protect themselve and that the government can be an enabler of those processes. It is also essential the recognition that not all communities at flood risk have the capacities to self-organise and protect themselves, but the government can help to build their capacities. The government should have a more coherent message, and the aid provided in the form of resilience or recovery grants would be better spent in a coherent framework to build the resilience of SMEs before the flood, and not after it. Although is important to mention that businesses that have flooded in the past know that this support is not enough to recover.

Targeting interventions

In order to target interventions, there is a need to understand not only the economic costs by size but also by sector, as this will help shape the message. For instance, where are the higher costs, and which are the essential things that SMEs in the manufacturing sector might need? They might need cash-flow support, while wholesale and retail might need access to their customer base; and home-based consultant services might need online services. It is also important to examine inherent characteristics of SMEs (e.g. their need to prioritise their survival), and identify barriers to tailor interventions. For instance, businesses find difficult to decide which information is reliable in terms of what works or not, apart from who they can rely on. The report sheds light on barriers and different ways to engage SMEs and increase the receptiveness of flood-risk and preparedness information, e.g. looking at the message, the timing, the tone, the messenger and the best channels.

Final Remarks

Creating a new Flood Re scheme that enables and prepares SMEs for a future of affordable insurance, where the government and the UK insurance industry join efforts to support and incentivise community resilience might not be the answer to all SMEs, if the political will and the industry appetite are not there. Explorations could be made to include some type of SMEs, such as home-based businesses, the smallest SMEs and landlords. Either way, a unified flood risk management framework for SMEs is urgently needed. This report offers valuable analysis and insights that can inform the development of this framework, and the various findings contribute to advance the discussion. Encouraging the creation of resilient SMEs is a worthy effort as the economic impacts they experience have ripple effects across local and regional economies. Moreover, wetter future winters that are expected with climate change, and black swans such as Covid-19 give us the opportunity to re-think the urgent need to increase the resilience of this vital actor of the socio-economic system, which not only drives employment and growth, but also constitutes an essential fabric of our communities.

Main messages

Flood protection policy framework. The Government should prioritise the development of a flood protection policy framework to increase the resilience of SMEs so they are prepared not only for the next flood, but also for future climate change, and other risks such as Covid-19.

Size matters. Examining the economic costs relative to turnover and number of employees reveal the real extent of the impacts of flooding on SMEs.

Economic costs are significant to the towns and cities. The negative consequences of flooding on SMEs exert ripple effects in their communities, thus their protection should be of interest to the wider community, local and national Government.

Market failure. There is imperfect information that insurers have on the economic costs of flooding on SMEs, and the effectiveness of property flood protection.

Affordable insurance. There is a genuine need to offer better and affordable insurance products to SMEs (particularly the smallest) in flood-risk areas.

Resilience measures considered in the price. Insurance could be a driver of self-protection if it is tied to the take-up of resilient measures and reflected on the price

Should Flood Re be extended to SMEs? Flood Re should not extended to SMEs in its current form, but there is a need to seize the opportunity to explore the creation of a new scheme focused on SMEs. Home-based businesses, the smallest and landlords should be prioritised.

About this policy brief

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This policy brief aims to highlight the evidence that has been found through this research to inform policy decision-makers in the public, private and third sectors. The views expressed in this brief represent those of the author and do not necessarily represent those of the host institutions or funders.

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About the author, Dr. Paola Sakai is a UKRI Research and Innovation Fellow working at the University of Leeds and a research associate of the Centre for Climate Change Economics and Policy and the Priestley International Centre for Climate. Her work focuses on climate change adaptation and resilience of SMEs, infrastructure and cities; health inequalities and the linkages with climate vulnerability; collaborative urban strategic planning and city-to-city cooperation; climate finance, climate-compatible development and SDGs.

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