DEVON & SOMERSET
FIRE & RESCUE AUTHORITY

REPORT REFERENCE NO.	**DSFRA/13/21**
MEETING	**DEVON & SOMERSET FIRE & RESCUE AUTHORITY**
DATE OF MEETING	**19 DECEMBER 2013**
SUBJECT OF REPORT	**FUTURE INSURANCE ARRANGEMENTS**
LEAD OFFICER	**Treasurer to the Authority**
RECOMMENDATIONS	***(a) That the Authority approves:*** ***(i) participation in establishing a Fire & Rescue Authorities Insurance Pool, with the Authority becoming a full member of the governing Hybrid Discretionary Mutual;*** ***(ii) use of the pooling arrangement for its corporate property, liability, motor and other miscellaneous insurance requirements for a minimum period of three years, through the pooling entity and with effect from 1 November 2014 (or as soon as practicable thereafter once final arrangements are in place);*** ***(iii) participation as a financial guarantor for supplementary premiums should claims against the pool exceed the funding available;*** ***(b) that the Treasurer and Clerk be asked to undertake all steps necessary to effect the decisions indicated at (a)(i) to (iii) above;*** ***(c) that approval be given to officers of this Authority serving as Directors of the pooling entity as required and that in this capacity the Service Risk and Insurance Manager (or his/her nominee) be authorised initially to represent the Authority's interests at any formal meetings of the pooling entity and to vote on behalf of the Authority.***

EXECUTIVE SUMMARY	This paper seeks approval for the Authority to form, in conjunction with other Fire and Rescue Authorities, a Hybrid Discretionary Mutual to act as a pool for insurance purposes. Under the pooling arrangements all the participating fire and rescue authorities would share financially with each other, on a proportionate basis, the cost of establishing a pool fund from which any loss incurred by an individual member of the insurance pool would be met. This proposal is being considered by eight other fire and rescue authorities, all of whom have worked together on insurance and risk management issues for the past 7 years. The paper seeks approval for membership of the proposed hybrid mutual, the provision of the necessary financial guarantees and the commitment to transfer insurances to the pooling entity from 1 November 2014 or thereafter subject to final arrangements being in place.
RESOURCE IMPLICATIONS	These will be contained from within existing resources. Additionally, participation in the mutual should see the Authority ultimately secure savings as identified in paragraph 6.1 of this report.
EQUALITY RISKS AND BENEFITS ANALYSIS (ERBA)	N/A.
APPENDICES	NONE
LIST OF BACKGROUND PAPERS	NONE

1. SUMMARY AND INTRODUCTION

1.1 Following completion of the latest insurance tender exercise it has become apparent that there remains a lack of effective competition in the market for insurance for fire and rescue authorities, creating a significant risk that future premiums could increase. Current arrangements also limit opportunities to deliver savings through greater collaboration and the realisation of the financial benefits from improved risk management and claims reduction. The Fire and Rescue Insurance Consortium (a group of nine fire and rescue authorities formed in 2008) has therefore examined alternative solutions to this problem and has identified a possible solution designed to alleviate these issues.

1.2 This paper seeks approval for the Authority to participate with other Fire and Rescue Authorities in forming a Hybrid Discretionary Mutual to act as a pool for insurance purposes. The paper also seeks approval for membership of the proposed company, the provision of the necessary financial guarantees and the commitment to transfer insurances to the pooling entity from 1 November 2014 or thereafter, subject to final arrangements being in place.

2. BACKGROUND

Fire and Rescue Authorities Mutual Limited (FRAML)

2.1 In 2005 a group of fire and rescue authorities commissioned a study to determine the possibility of achieving savings in insurance costs through an alternative vehicle to purchasing insurance in the open market. The study concluded that a mutual insurance company was the preferred option and consequently, in 2007, the Authority participated in the creation of the Fire and Rescue Authorities Mutual (FRAML). Due to a legal challenge (Brent LBC v Risk Management Partners - 2009) to a similar company covering nine London Boroughs, the arrangements proposed for FRAML were halted. Since that time, however, nine fire and rescue authorities have formed the Fire and Rescue Insurance Consortium (FRIC) to collaborate and purchase insurance conventionally as well as improving risk management and reducing the costs of high value claims.

Pooling

2.2 Insurance premiums cost the Authority around £766k per annum currently and, given recent claims experience across the other fire and rescue authorities, FRIC has been looking at how insurance costs can be reduced. It has now completed a feasibility study and identified a possible long term solution to establishing better control of premium costs, involving the creation of a shared “pooling” arrangement.

Pooling Concept Feasibility Study Report

2.3 In March 2013 the nine fire and rescue authorities in the insurance consortium commissioned Regis Mutual Management to explore various alternative financing scenarios using five years’ claims experience for all nine authorities. Regis issued their Pooling Concept Feasibility Study Report in May 2013 and this recommended the formation of an entity to act as a pooling mechanism to allow all nine fire and rescue authorities to share risk and thereby reduce insurance costs. The recommended approach is for the creation of a Hybrid Discretionary Mutual with a “discretionary” pool for attrition losses, backed by conventional insurance for larger individual losses and high volumes of claims. The use of such a discretionary route is well established and is enshrined in the Financial Conduct Authority (formerly Financial Services Authority) handbook. A full copy of the Feasibility Study Report is available to Members on request.

3. ESTABLISHMENT OF HYBRID DISCRETIONARY MUTUAL – ISSUES FOR CONSIDERATION

General

3.1 The establishment of a “mutual” to manage a discretionary pooling of funds to meet losses is a recognised alternative to conventional insurance. It is common amongst other groups of organisations such as Universities who share common risks. When the size of each body is not sufficiently large to carry the risk of a large policy deductible or excess these cost saving benefits can be achieved through a discretionary pool.

Appointment of Directors

3.2 Directors of the mutual would be drawn from participating fire and rescue authorities but no single fire and rescue authority would have the right to appoint a Director as there are likely to be fewer Director appointments than participating fire and rescue authorities so as to keep costs to a minimum. Practically, it is proposed that (as with FRAML) the Directors are drawn from appropriate professionals within the participating fire and rescue authorities based on the experience, knowledge and expertise required, supplemented by one or two experienced insurance industry figures.

Day to Day management

3.3 The mutual would be run on a day to day basis by professional managers appointed by the mutual. They will be required to meet all the necessary professional requirements of the Financial Conduct Authority and would also bring experience and specialist market knowledge as well as providing financial modelling and claims management.

Discretion in practice

3.4 The discretionary element is a legal device to ensure that the arrangement is not treated as an insurance company, which would require significant working capital to be deposited, and there have been a number of legal judgements confirming this position. However, it does mean that the Authority would have no absolute guarantee that any particular claim would be paid albeit that such decisions would rest with the Directors of the pool who would have the power to agree to meet any claim made. In practice, there is a similar risk with an insured arrangement if the precise terms and conditions of the insurance contract are not met. Also, in practice, the basis of the pooling arrangement is one of mutual trust and if a claim was not met then there is a risk that pool members would leave causing the pool to collapse, to the detriment of all.

4. POOL INSURANCE STRUCTURE

Pool size

4.1 The pool size will depend on the type of risks it accepts. It is proposed that the pool targets the areas of highest external premium spend, namely motor fleet and employers/public liability, but that it should also cover property. It is therefore proposed to use the pool to cover the Authority’s corporate property, liability, motor and other miscellaneous insurance requirements.

Annual premiums and excesses

4.2 Under the proposed pool structure, each fire and rescue authority would pay in a "premium" by way of a contribution to the costs of the pool (including management and running costs) based on its own individual claims experience, excess levels and cover requirements. These have been assumed, for the sake of the feasibility study, to be the same as the current insurance premiums but would be recalculated by the appointed managers based on prevailing circumstances at the inception of the pool. Each fire and rescue authority would also continue to meet its existing levels of excess and would fund these from its own budgets as now.

Retentions

4.3 After individual fire and rescue authorities have paid their excess amounts on any claims the pool would meet the next layer of claim costs up to the sums set out in the table overleaf for each class of insurance.

<table>
<tr><td>Fleet Retention[1] per Claim</td><td>£1.00m</td><td rowspan="3">Cross Class Aggregate Insurance[2] for retained losses between £2m and £5m. Excess Layer insurance[3] beyond £5m</td></tr>
<tr><td>Liability Retention per Claim</td><td>£0.25m</td></tr>
<tr><td>Property Retention per Claim</td><td>£0.10m</td></tr>
<tr><td>Risk Gap / Supplementary Call</td><td colspan="2">£0.20m or 5.5% of Contributions</td></tr>
</table>

(Notes:

[1] The amount paid out of the Pool's funds

[2] An aggregate insurance policy with an attachment point applying across the sum of claims for two or more classes of insurance.

[3] An insurance policy covering the loss in excess of a stated amount).

Cross Class Aggregate and Excess Layer Insurance

4.4 To protect the pool from a spike in claim numbers or costs in any one year, a further layer of conventional insurance would be purchased for all individual claims over the £1m limit and for all costs exceeding £2m in total (regardless of the claim type) falling in any one policy year. These policies would be purchased by the pool managers as collective policies on behalf of the member fire and rescue authorities jointly, ensuring the pool remains solvent in the medium to long term.

Risk gap/Supplementary Call

4.5 The loss models used by the consultants have identified a slight risk that, should the claims profile peak in the early years of the life of the pool, it is possible that a gap between the £2m limit and the funds available might arise. In the worst case scenario model, this is not expected to exceed £200k; the cost of which would be shared pro-rata to current premiums by the pool members. Member fire and rescue authorities will be required to provide guarantees of funding against such supplementary calls if the pool is to be sustained before it is able to build up its balances. To achieve this, a provision for supplementary calls will be included in the pooling arrangements.

Specialist insurance

4.6 Whilst the main, commonly held policies will be sourced via the pool, a small number of specialist policies may continue to be purchased outside of the pooling arrangements, but these are expected to fall below the thresholds that require compliance with European procurement rules.

Limitation of liability

4.7 In essence, subject to the final structure of the pool arrangements, if all pool funds are completely eroded before the end of the period all the external insurance policies will revert to a conventional basis. Therefore the liability of the pool in any one year is finite and predictable.

Claims handling

4.8 The chosen solution for handling claims falling to the pool will be determined by the mutual.

5. INTERIM INSURANCE ARRANGEMENTS

5.1 As the Authority’s current insurance arrangements were due to expire this year it has been necessary to procure interim cover until the proposed pooling arrangements are implemented. The insurance consortium previously procured insurances as a group with effect from 1 November 2008. All insurances were awarded to Zurich Municipal. During the last two years of the five year agreement there have been sizeable increases in the rates for motor and liability premiums following a small number of high value claims. The consortium has used a new framework arrangement put in place by the Government Procurement Services (GPS) in partnership with the PRO5 group of local authority buying consortia to conduct the latest procurement for insurance, effective from 1 November 2013. This has been let for one year, with an optional one year extension, rather than the previous practice of three years plus an optional two year extension. This was designed to be a short term contract to test efficacy of the GPS framework, assess the current market appetite for insuring fire and rescue authority risks in light of the additional data made available and to enable time for an alternative source of risk finance should the response be unfavourable.

5.2 As part of the procurement process, considerable effort was made to provide potential insurers with detailed and independently validated risk information, to address some of the misconceptions about blue light risks and to tailor the cover requirements to our specific needs. Whilst the tender has produced some limited savings across the programme as a whole compared to 2012-13 premiums, the net cost is still above that paid prior to the recent price increases in 2012, after taking account of changes in sums insured. For this Authority, the additional cost is around £3,000 for 2013/14.

5.3 The result also suggests that there is still limited appetite, and therefore limited competition, for insuring blue light services such as fire and rescue authorities despite these efforts. There were only a few interested bidders despite the lengthy list of prospective insurers on the framework, and a marked reluctance from most to tailor the cover to meet the specific needs of fire and rescue authorities. In addition, many insurers are not willing to recognise the improvements in risk management arrangements and the declining activity levels, which have resulted in lower loss ratios which benefit the insurer. These procurement issues instigated the original decision to form a mutual insurance company back in 2007 and remain a strong driver for seeking an alternative solution in the future.

6. RISK AND IMPACT ASSESSMENT

Financial modelling

6.1 Based on the historic claims experience of the nine fire and rescue authorities the most likely outcome would be a saving of some £1.5m out of total cumulative premiums of £19.7m - a saving of 7.6%, shared across the nine fire and rescue authorities over the five year period. If this percentage saving is realised and the mutual decides to reduce future member contributions accordingly, savings of around £42,000 per annum could be realised, based on the 2012 data used in the financial model. This could easily increase if risk management activities succeed in reducing claims costs, as these benefits would accrue to the members of the mutual rather than adding to the profits of the insurer - as is currently the case. In addition, it is likely that the mutual would be able to stabilise premiums reducing the impact of market fluctuations and removing a large part of the risk taken each time a tender process is undertaken.

6.2 Under this modelling scenario there may however be the need for supplementary premiums in some years should the claims profile vary significantly from the model used; it is estimated that these are unlikely to exceed 5.5% of annual contributions in any one year.

6.3 Once established, any running costs for the pool will be met from the contributions made to it by its members. In overall terms it is intended that over the medium term at least, this will lead to net savings, so no additional costs should fall to be financed by the Authority once the pool is established, unless a supplementary contribution is required as indicated in paragraph 4.5 above. It is likely, however, that the Authority would have to contribute to the cost of tendering for a pool manager and establishing the company as an approved entity. These costs have been estimated at circa £100,000 which would be shared equally between the nine participating fire and rescue authorities. The Authority's share, assuming all nine fire and rescue authorities agree to join the pool, would be circa £12,000. In the medium to long-term, any initial costs would be offset by increasing savings from the pool which, if claims continue to be managed down, will enable annual contributions to be reduced.

7. LEGAL BASIS FOR THE MUTUAL

7.1 In Brent LBC v Risk Management Partners [2009] the Court of Appeal affirmed the decision of the High Court that Brent had no power under either:

- section 2 of the Local Government Act 2000 (the well-being power); or
- section 111 of the Local Government Act 1972.

to become a member or participating member of London Authorities Mutual Limited (LAML), a company limited by guarantee or to make payments or to enter into commitments to make payments to LAML.

7.2 As indicated in paragraph 2.1 above, however, on the basis of this legal ruling the initial proposals for FRAML were halted.

7.3 In response to this ruling Parliament provided, via section 34 of the Local Democracy, Economic Development and Construction Act 2009, the power for local authorities including fire and rescue authorities to establish mutual insurance arrangements albeit that this provision has not been brought into force to date.

7.4 Section 9 of the Localism Act 2011, however, introduced certain general powers for combined fire and rescue authorities. Specifically, Section 5A was inserted into the Fire and Rescue Services Act 2004. This provides:

"(1) A relevant fire and rescue authority may do-

(a) anything it considers appropriate for the purposes of the carrying-out of any of its functions (its "functional purposes"),

(b) anything it considers appropriate for purposes incidental to its functional purposes,

(c) anything it considers appropriate for purposes indirectly incidental to its functional purposes through any number of removes,

(d) anything it considers to be connected with—

(i) any of its functions, or

(ii) anything it may do under paragraph (a), (b) or (c), and

(e) for a commercial purpose anything which it may do under any of paragraphs (a) to (d) otherwise than for a commercial purpose.

(2) A relevant fire and rescue authority's power under subsection (1) is in addition to, and not limited by, the other powers of the authority."

7.5 This new power overcomes the problem in the Brent case meaning that the Authority now has the legal power to become a member of a company and to make payments to that company for the purposes of providing mutual insurance cover.

7.6 In light of the above, it is not anticipated that any legal challenge will be made to establishment of the mutual or that any legal challenge, if so made, would be successful.

7.7 Participation in the pool does not constitute public service procurement and is not therefore subject to European tender regulations. As a wholly-owned public sector body, however, any external procurement the pool makes would have to be undertaken in accordance with those rules.

8. CONCLUSION

8.1 Establishment of and participation by this Authority in a "mutual" as envisaged in this report presents the opportunity for a lawful, innovative approach for securing insurance that should deliver better value for money, greater incentive for risk-management activities to reduce claim costs and ultimately reduced costs for this Authority in terms of premiums etc. The approach is, therefore, commended to the Authority.

KEVIN WOODWARD
Treasurer to the Authority