

Hampshire Fire and Rescue Authority

Finance and General Purposes Committee

Item: 11

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Proposed future insurance arrangements

Report by the Chief Officer

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1 Introduction

- 1.1 Following completion of the latest insurance tender exercise it has become apparent that there remains a lack of appetite 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 (FRIC)¹ has therefore examined alternative solutions to this problem and identified a possible solution designed to alleviate this.
- 1.2 This report seeks approval for the Committee to recommend to the Authority to participate with other fire and rescue authorities in forming 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 losses within a certain financial criteria incurred by an individual member of the insurance pool would be met. It 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.
- 1.3 This proposal is being considered by eight other fire and rescue authorities who have worked together on insurance and risk management issues for the past seven years. At the time of writing this report five of the nine have received approval from their authorities. The remainder are making their proposals during January and February

¹ Bedfordshire and Luton Fire and Rescue Authority, Cambridgeshire and Peterborough Fire Authority, Cheshire Fire and Rescue Authority, Devon and Somerset Fire and Rescue Authority, Essex Fire and Rescue Authority, Hampshire Fire and Rescue Authority, Kent and Medway Towns Fire Authority, Leicestershire and Rutland Fire and Rescue Authority, Royal Berkshire Fire and Rescue Authority.

2014.

2 Recommendations

That it be a recommendation to the Authority:

- 2.1 That it participate in establishing a Fire and Rescue Authorities' Hybrid Discretionary Mutual to pool insurance and become a full member of it, subject to the appropriate governance arrangements being in place.
- 2.2 That the Director of Corporate Services and Treasurer are authorised to take all necessary steps to achieve this.
- 2.3 That the Authority agrees to use the pooling arrangement for its corporate property, liability, motor and other miscellaneous insurance requirements for a minimum period of three years with effect from 1 November 2014 or thereafter, subject to final arrangements being in place (paragraph 4.5.1 refers).
- 2.4 That the Authority agrees to participate in a financial guarantee for supplementary premiums should claims against the pool exceed the funding available (paragraph 4.9.1 refers).
- 2.5 That the Authority agrees that officers may serve as Directors of the pooling entity and be empowered to represent the Authority's interests at any formal meetings and to vote on its behalf (paragraph 4.3 refers).

3 Background

3.1 Fire and Rescue Authority Mutual (FRAML)

- 3.1.1 In 2005 a group of nine fire and rescue authorities (FRAs) 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 from a similar company covering nine London Boroughs, the arrangements had to cease in 2008. Since then, nine FRAs have formed the Fire and Rescue Insurance Consortium (FRIC) in order to collaborate and purchase insurance conventionally as well as improving risk management and reducing the costs of high value claims. Changes in the law have now made this proposal possible as explained in paragraph 8.2 below.

3.2 2013 procurement process

- 3.2.1 As part of the recent 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 was around £47.5k for the current year.

- 3.2.2 The result also suggests that there is still limited appetite, and therefore limited competition, for insuring blue light services such as FRAs 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 FRAs. 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.

4 Pooling

- 4.1 Insurance premiums cost the Authority around £550k per annum. Given recent claims experience across the other FRAs, and the recent tendering exercise mentioned in paragraph 3.2.2, FRIC has been looking at how insurance costs can be reduced. It has 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.

4.2 Feasibility study into ‘Pooling’ – Pooling Concept Feasibility Study Report

- 4.2.1 In March 2013 the nine FRAs in FRIC 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 FRAs to share risk and thereby reduce insurance costs. A pool is an entity formed by a group of persons or companies (the “members”) exposed to some risk or contingency common to the group who are prepared to share financially with each other, on a proportionate basis, the cost of any loss or predetermined level of risk incurred by an individual member, if the contingency occurs to the member.
- 4.2.2 The recommended approach is for the creation of a Hybrid Discretionary Mutual with a “discretionary” pool for the attritional losses, and 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.
- 4.2.3 The Hybrid structure is based on the discretionary mutual retaining a

portion of each risk subject to a predetermined finite figure (an aggregate limit) and then the mutual arranging an insurance policy to sit above the mutual's retention with all members named as an insured on that policy (a group excess of loss policy). In this way the members can all say that they are 'insured' under the group policy but with a high excess which is covered by their discretionary mutual. This has the added advantages that a letter of credit from the mutual in favour of a fronting insurer only needs to cover the mutual's retention and not the whole risk (see Section on escrow) and there is still a substantial IPT benefit in that the contributions remaining in the mutual do not attract IPT.

4.2.4 The establishment of a company 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. The setting up of the company would be one of the first workstreams in the project and appropriate guidance sought and taken.

4.2.5 **Discretion in practice** - The discretionary element means that the arrangement is not treated as an insurance company, thereby requiring significant working capital to be deposited, and there have been a number of legal judgements confirming this view. It does mean that the Authority would have no absolute guarantee that any particular claim would be paid. However 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 the pool could collapse to the detriment of all.

4.3 **Appointment of directors**

4.3.1 Directors of the mutual would be appointed by the participating FRAs but no single FRA would have the right to appoint a Director as there are likely to be fewer Director appointments than participating FRAs in order to keep costs to a minimum. As with FRAML, it is proposed that the Directors are drawn from appropriate professionals within each participating FRA based on the experience, knowledge and expertise required, supplemented by one or two experienced insurance industry figures.

4.4 **Day to day management**

4.4.1 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.

4.5 Pool insurance structure – pool size

4.5.1 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.

4.6 Annual premiums and excesses

4.6.1 Under the proposed pool structure, each FRA 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 FRA would also continue to meet its existing levels of excess and would fund these from their own budgets as now.

4.7 Retentions

4.7.1 After individual FRAs 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 below for each class of insurance.

Fleet Retention per Claim (1)	£1m	Cross Class Aggregate Insurance (2) for retained losses between £2m and £5m. Excess Layer insurance (3) beyond £5m
Liability Retention per Claim	£250k	
Property Retention per Claim	£100k	
Risk Gap / Supplementary Call	£200k or 5.5% of contributions	

(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. To explain this, an aggregate can remove the concern that in a 'bad' year the cumulative value of claims up to the level of the excess may be greater than it is in an 'average' year. An aggregate stop kicks in when claims within the excess reach an agreed total. After this, claims for that period of insurance, become the responsibility of the insurer on a 'ground up' basis. This therefore introduces an element of 'budgetary certainty'. In a worst case scenario the Authority's maximum exposure, for claims below the excess, is capped by the aggregate. These can be on a 'cross class' basis where the aggregate applies across two or more classes – e.g. liability and motor – at the same time.

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

4.7.2 The cost of claims would be met in three ways;

1. By each FRS up to the agreed excess level.
2. By the pool, for costs above the excess up to a certain limit.
3. By external insurance for high value or volumes of claims.

For example, we currently have a nil excess limit on our fleet policy for damage to third parties. If we have a claim amounting to £25k, this would be paid by the pool. A claim of £1.5m would be paid via an external insurance policy.

4.8 Cross class aggregate and excess layer insurance

4.8.1 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 FRAs jointly, ensuring the pool remains solvent in the medium to long term.

4.9 Risk gap/supplementary call

4.9.1 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 FRAs 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.

5 Specialist insurance

5.1 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.

6 Limitation of liability

6.1 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.

7 Interim insurance arrangements

- 7.1 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 has procured insurances as a group since November 2008. All insurances were awarded to Zurich Municipal.
- 7.2 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 FRA 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.

8 Resource implications

8.1 Financial

- 8.1.1 **Financial modelling** - Based on the historic claims experience of the nine FRAs 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 FRAs over the five year period. If this percentage saving is realised and the mutual decides to reduce future member contributions accordingly, savings of around £42k 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 currently. 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.
- 8.1.2 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; these are estimated to be unlikely to exceed 5.5% of annual contributions in any one year.
- 8.1.3 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 4.9 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 have been estimated at circa £100k, which would be shared equally between the member FRAs involved. The Authority's share, assuming all nine FRAs agree to join the pool, would be around £11-12k. 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.

8.2 Legal basis for the mutual

8.2.1 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 power of wellbeing), or
- Section 111 of the Local Government Act 1972

to become a member or participating member of the London Authorities Mutual (LAML), a company limited by guarantee, nor to make payments nor enter into commitments to make payments to LAML. As indicated in paragraph 3.1 above, on the basis of this ruling, initial proposals for the Fire and Rescue Authorities Mutual (FRAML) were halted.

8.2.2 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.

8.2.3 Section 9 of the Localism Act 2011 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 (subject to certain limitations contained in section 5B). In sub-sub-paragraph (1) (b):

- (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
 - (1) Any of its functions
 - (2) Anything it may do under paragraph (a), (b), or (c), and
 - (e) For commercial purpose anything which it may do under any of the 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.

8.2.4 This new power overcomes the Brent case meaning that the Authority now has legal power to become a member of the company and to make payments to that company for the purposes of providing mutual insurance cover. In light of this, it is not anticipated that any legal challenge, if made, would be successful.

8.2.5 Participation in the pool does not constitute public service procurement and is therefore not subject to European tender regulations. However as a wholly owned public sector body, any external procurement the pool makes would need to be undertaken in accordance with these rules.

8.3 Human Resources

8.3.1 Current insurance arrangements are dealt with by the Performance Review Manager and the Insurance and Risk Officer. There will be no change in the current arrangement and no requirement for any additional personnel.

8.4 Physical resources

8.4.1 There will be no additional physical resources required.

8.5 Information and communications technology resources

8.5.1 There will be no additional information and communications technology resources required.

9 Risk analysis

9.1 Insurance cover is a method of 'treating' risk. It is important to be aware of the potential financial risk that could arise in the day to day activities of a fire and rescue service. For this reason it is essential that appropriate insurance provision is purchased in order to minimise potential financial risks to the Authority. It is also important to bear in mind that insurance does not replace the need for appropriate risk management procedures to help prevent the likelihood of these risks occurring.

9.2 The operation of a pooling arrangement in place of conventional insurance carries its own risks. There will be a potential call for supplementary contributions if the overall claims experience of the pool exceeds the year's contributions and any carried forward surplus. This is therefore a higher risk in the early years of the proposed arrangements.

9.3 At the other end of the risk spectrum there is potential opportunity for significant reductions of 10% to 20% in our annual insurance costs, both through lower premiums and lower levels of losses.

9.4 There is risk in sharing claims experiences. If other FRA's suffer large losses, this will affect the other members of the pool. However, the

Consortium has worked on this principle for the last five years where we have been buying insurance together. Our joint risk profile is what insurers price our cover on. On the other hand one large loss in a pool can have potentially less impact on costs than if it were a single FRA with one policy.

- 9.5 The nine FRAs in FRIC have worked together over the past years to develop a risk management process and to share best practice, including the benchmarking of risk management arrangements against best practice and a commitment to work to meet this standard. These activities are designed to help all participating FRA's reduce the cost of claims and thereby insurance costs. The most recent benchmarking report was commissioned in the first half of 2013 and the work was carried out on behalf of FRIC by Paragon Risk Engineering.
- 9.6 The benefits from the shared approach to best practice in risk management provides a significant opportunity to drive down both the direct and indirect costs associated with incidents that lead to insurance claims. The benefits of these improvements would fall to the authorities participating in the pool, through potentially lower future contributions, rather than paying extra costs to conventional insurers.
- 9.7 As explained in paragraph 4.6.1 the feasibility was based on the last five years' experience and the model was based on current premiums. If the proposal goes ahead this will be recalculated. There is a very small risk that this will increase our premiums. This is unlikely as claims experiences did not appear to increase during the last insurance year (November 2012 to October 2013), although we are currently awaiting data for the whole consortium.

10 People impact assessment

- 10.1 The proposals in this report are considered compatible with the provisions of the equality and human rights legislation.

11 Background papers

The following documents disclose the facts or matters on which this report, or an important part of it, is based and has been relied upon to a material extent in the preparation of the report:

None

Note: The list excludes: (1) published works; and (2) documents that disclose exempt or confidential information defined in the Act.