Providing powers for best value authorities to participate in mutual insurance arrangements

Impact assessment

www.communities.gov.uk
community, opportunity, prosperity

Providing powers for best value authorities to participate in mutual insurance arrangements

Impact assessment

October 2009
Department for Communities and Local Government

Department for Communities and Local Government
Eland House
Bressenden Place
London
SW1E 5DU
Telephone: 030 3444 0000
Website: www.communities.gov.uk

© Crown Copyright, 2009

Copyright in the typographical arrangement rests with the Crown.

This publication, excluding logos, may be reproduced free of charge in any format or medium for research, private study or for internal circulation within an organisation. This is subject to it being reproduced accurately and not used in a misleading context. The material must be acknowledged as Crown copyright and the title of the publication specified.

Any other use of the contents of this publication would require a copyright licence. Please apply for a Click-Use Licence for core material at www.opsi.gov.uk/click-use/system/online/pLogin.asp, or by writing to the Office of Public Sector Information, Information Policy Team, Kew, Richmond, Surrey TW9 4DU

e-mail: licensing@opsi.gov.uk

If you require this publication in an alternative format please email alternativeformats@communities.gsi.gov.uk

Communities and Local Government Publications
Tel: 030 0123 1124
Fax: 030 0123 1125

Email: product@communities.gsi.gov.uk
Online via the Communities and Local Government website:
www.communities.gov.uk

October 2009

ISBN: 978 1 4098 1952 3

Summary: Intervention and options

Department /Agency: Communities and Local Government	Title: Impact assessment of providing powers for best value authorities to participate in mutual insurance arrangements	
Stage: FINAL	Version: FINAL	Date: 09 October 2009

Related Publications: Strengthening Local Democracy, consultation paper (Communities and Local Government, June 2009)

Available to view or download at:

http://www.communities.gov.uk/publications/localgovernment/localdemocracyconsultation

Contact for enquiries: Andrew Cornelius **Telephone:** 0303 4444 2647

What is the problem under consideration? Why is government intervention necessary?

A recent Court of Appeal judgment has ruled that local authorities do not have powers to undertake mutual insurance arrangements, in particular in line with those arrangements set up by a group of London local authorities in the London Authorities' Mutual Limited (LAML). As part of the continued drive towards efficiency, the Government's view is that mutual insurance is an activity which local authorities should be able to undertake and wishes to ensure that local authorities have the necessary powers to engage in such activities where it delivers best value for the taxpayer.

What are the policy objectives and the intended effects?

The objective of the policy is to permit local authorities to be able to participate in mutual insurance arrangements. It is the intention that these activities should be suitably regulated and therefore the proposal is for local authority mutual insurance activity to be subject to regulation by the Financial Services Authority (FSA).

What policy options have been considered? Please justify any preferred option.

The policy option that has been considered is to 'provide powers for local authorities to undertake mutual insurance arrangements in line with those set up in the LAML model'. The intervention is due to a need within local government to provide local authorities with the range of necessary powers. As such, given the scope for improved competition in the local government insurance market, the recommended approach is to provide local authorities with powers to participate in mutual insurance arrangements.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? The Department will look at how the impact of the policy can be monitored and evaluated through its programme of local government research. However, it is likely that the review will be undertaken as part of on-going studies into local government efficiency.

Ministerial sign-off For final proposal/implementation stage impact assessments:

I have read the impact assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible minister:

....Date: 13 October 2009

Summary: Analysis and evidence

Policy Option: Enact Proposed enabling power	**Description:** Local authorities would be able to establish mutual insurance schemes

0

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	The proposed legislation does not entail any direct costs for local authorities as it is an enabling power, giving local authorities the discretion to use it.
£		
Average Annual Cost (excluding one-off)		
£		**Total Cost** (PV) £

Other **key non-monetised costs** by 'main affected groups' Local authorities *could* decide to test the feasibility of creating one or more mutual schemes and if justified, *could* proceed towards creating a scheme. In this case, significant costs encompassing feasibility, set-up and capitalisation would be incurred. These costs are illustrated in the Evidence Base section.

In addition, local authorities entering into a mutual insurance arrangement may have to accept a higher level of risk than under an insured arrangement. Whilst the mutual is likely to reinsure some risks, in its early years the mutual needs to builds up reserves to meet unexpected claims (which could take 15 -20 years). During this period, participating local authorities could be asked for supplementary capital contributions to support the capital reserves of the mutual.

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	The benefits cannot be monetised with any level of certainty.
£		
Average Annual Benefit (excluding one-off)		
£		**Total Benefit** (PV) £

Other **key non-monetised benefits** by 'main affected groups'

The expected key general effect of the legislation is to increase competition amongst suppliers of insurance services to local authorities, if not through the actual creation of a mutual then through the *threat* of one being created. Either effect should exert downward pressure on premiums but it is difficult to describe with any certainty what would be the exact impact on insurance premiums as a consequence of the legislation. Some consultees in the supporting study to this assessment suggested that the London focused mutual led to more competitive pricing on the part of private insurers. A brief illustration of the potential overall benefit of increased competition is shown in the accompanying Evidence Base.

Particular benefits could accrue to any established mutual over time. These could be lower than market rate premiums arising from the non-profit taking nature of these schemes as well as through improved risk management brought about by shared intelligence and best practice among participants. Although the scale of realisation of these benefits would ultimately depend on the responses made by private insurers.

Key Assumptions/Sensitivities/Risks

It is assumed, based on previous evidence, that local authorities will engage in creating mutual insurance schemes if the prices of premiums offered by private insurers diverge excessively from those that would be payable under mutual insurance schemes.

However, it is also assumed that private insurers will seek out means of reducing their costs and margins in order to be able to offer more competitive premiums to local authorities – with a view to deterring potential local authority organised entrants.

Price Base Year	Time Period Years	**Net Benefit Range** (NPV) **£**	**NET BENEFIT** (NPV Best estimate) **£**

What is the geographic coverage of the policy/option?			England and Wales	
On what date will the policy be implemented?				
Which organisation(s) will enforce the policy?			Regulated by the FSA	
What is the total annual cost of enforcement for these organisations?			£	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			N/A	
What is the value of the proposed offsetting measure per year?			£	
What is the value of changes in greenhouse gas emissions?			£	
Will the proposal have a significant impact on competition?			Yes	
Annual cost (£-£) per organisation (excluding one-off)	Micro **N/A**	Small **N/A**	Medium **N/A**	Large **N/A**
Are any of these organisations exempt?	Yes/No	Yes/No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)
Increase of £	Decrease of £	**Net Impact £**

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

Evidence Base (for summary sheets)

Introduction

1. This impact assessment reports on the impact of providing powers for local authorities to enter into mutual insurance arrangements. This follows the outcome of a Court of Appeal judgment which ruled that local authorities do not have the power to set up and participate in mutual insurance arrangements. This impact assessment also reports on the outcome of the aspects of the consultation paper, *Strengthening Local Democracy*[1] (Communities and Local Government, July 2009), relating to mutual insurance. Amendments have been tabled to the Local Democracy, Economic Development and Construction Bill ('the LDEDC Bill') which will give effect to the proposal.

Background

London Authorities Mutual Limited (LAML)

2. In 2007, 10 London local authorities set up the London Authorities Mutual Limited (LAML), a guaranteed indemnity mutual insurance company. The decision was reported to have been taken in response to a lack of competition in the local authority insurance market, with the intention to deliver significant efficiency savings. LAML went live on 1 April 2007 with two of the ten founding authorities, Brent LBC and Harrow LBC, placing their insurances.

3. LAML was a registered company, owned by its member local authorities, and regulated by the Financial Services Authority (FSA) as an authorised insurer. The company was guaranteed by the participants themselves with no third party shareholders. The Board of Directors were drawn from London Borough Directors of Finance.

Procurement exercise

4. We understand that Brent ran a procurement exercise which they later discontinued when they placed their insurance contract with LAML. Risk Management Partners (RMP) was one of the respondents to the procurement exercise and subsequently claimed that the council acted in breach of the public procurement regulations by abandoning the procurement exercise and awarding some of the insurances to LAML.

Court cases

5. As a result, RMP took action against Brent on two counts. Firstly, to establish whether Brent had the powers to participate in LAML (the *vires* judgment) and, secondly, for breach of the public procurement regulations (the procurement judgment). The High Court ruled against Brent on both instances but leave to appeal was granted.

6. Brent appealed the Judgment on both vires and procurement, with Harrow and LAML appealing as Interested Parties where appropriate. The Court of Appeal Judgement was delivered in June 2009 and Brent again lost the appeal on both grounds.

Mutual insurance research

7. Research by the Association of Mutual Insurers (AMI)[2] showed that in 2007 PLC insurers paid out on average 3.1p to shareholders for every £1 invested by their customers. AMI claims that as mutual insurance companies do not have any shareholders, this money can be redistributed back to its members and customers. AMI represents 36 mutual insurers and they claim that other benefits include greater levels of trust and also higher customer satisfaction levels.

---

[1] http://www.communities.gov.uk/publications/localgovernment/localdemocracyconsultation
[2] http://www.mutualinsurers.org/index.php?option=com_content&view=article&id=56&Itemid=9

Reason for intervention

8. The Government recognises that there is a need to provide an effective legal framework that enables local authorities and other best value authorities, such as police and fire and rescue authorities[3], to undertake appropriate activities to service their communities and to deliver efficiencies.

9. The Court of Appeal judgment has now ruled that local authorities cannot undertake mutual insurance arrangements in line with those set up by LAML. As part of the continued drive towards efficiency, the Government's view is that mutual insurance is an appropriate activity for local authorities to undertake and wishes to ensure that local authorities have the necessary powers to engage in such activities where it delivers best value for the taxpayer.

Policy objectives

10. The objective of the policy is to permit local authorities to be able to participate in mutual insurance arrangements. It is the intention that these activities should be suitably regulated and therefore the proposal is for local authority mutual insurance activity to be subject to regulation by the Financial Services Authority (FSA).

Links to other policy areas and strategies/programme of work

11. The Government has long sought to liberalise the local government services market and the proposal on mutual insurance is a continuation of that drive. The introduction of the trading powers in the Local Government Act 2003 has permitted local authorities act to fill gaps in service provision or to act locally to provide new competition in the market. These trading powers have recently been extended to all local authorities and fire and rescue authorities.

12. The recently published consultation paper, *Strengthening Local Democracy*, set out the Government's drive to renew Britain's democracy and build trust in the political system. As part of that consultation, the Government is also looking at the scope of local authority powers, in particular around their powers to undertake mutual insurance arrangements, but also to establish what other powers local authorities may need to improve services and deliver efficiencies. Providing powers on mutual insurance should be seen as complementing that wider look at local authority powers.

Summary of independent study into cost-benefit analysis

13. To assist in the determination of the costs and benefits resulting from the proposed legislation, the Department commissioned a small study from an independent consultancy (LG Futures) to undertake some economic research and to help determine the potential impacts. This is annexed to this impact assessment. The following summarises that study.

Background/Introduction costs and benefits

14. The proposed legislation provides local authorities with a discretionary power to establish mutual insurance schemes which would be regulated by the Financial Services Authority. Because it is an enabling power, there is no certainty that a LAML type approach will be established as a result of the legislation. However that does not mean that the proposed legislation is not likely to have any impact.

---

[3] All references to local authorities is also a reference to best value authorities as defined in section 1 of the Local Government Act 1999.

15. Indeed, because private insurers are already providing this as an outsourced service, we have to consider how existing insurers respond and the local authorities might act. We would look at the likelihood of their actions in the light of the proposed legislation.

What are the possible impacts?

16. There are two inter-related impacts which could results from the legislation one on the behaviour private insurers and on behaviour of local authorities which are described below.

Private insurers

17. The local government insurance market has a relatively small number of private insurers, with one perceived dominant company. The resources required to comply with exacting public sector procurement practices is considered to deter wider private sector involvement.

18. The legislation, by enabling local authorities to establish mutual insurance schemes, introduces additional *potential* suppliers into the local authority insurance market. However, the fact that the LAML scheme was successfully established and was regarded by its participants are being cost effective makes such potential competition more real than theoretical. Given the threat of potential competition, private insurers may respond by seeking out means of reducing their costs and margins in order to be able to offer lower premiums to local authorities.

Local authority mutual insurance schemes

19. No business case concerning the establishment of an insurance mutual is likely to be approved by a participant authority unless there is evidence that a mutual could deliver clear financial and risk management advantages over alternative arrangements. Local authorities entering into a mutual insurance arrangement accept a higher level of risk than under an insured arrangement. Whilst the mutual is likely to need to reinsure significant risks over time, the mutual also needs to build up reserves to meet unexpected claims (which could take 15 -20 years). During this period participating local authorities could be asked for supplementary capital contributions to support the capital of the mutual. Consequently, the creation of any mutual insurance scheme is going to be dependent on an assessment of current and future premiums offered by private insurers and an analysis of the risk implications. The annexed supporting study provides some illustrations of levels of premia and number of participants that would be required to provide varying levels of accumulated surpluses within a mutual insurance scheme.

20. Before going on to present evidence on the impact that the legislation may have – the costs and benefits of the two insurance models are briefly addressed.

Background on local government insurance costs

21. The overall market for local authority insurance in England is in the region of £300m and £600m. Which means that even modest discounts in the cost of premiums could deliver notable savings for the local authority sector in general.

Private sector insurance

22. The results from interviews undertaken as part of the supporting study suggest that larger[4] authorities typically spend between £750,000 and £1m per annum on insurance premiums,

[4] For the purposes of our review, we have defined unitaries, metropolitan districts, London boroughs and county councils as 'larger authorities'.

while smaller[5] authorities spend between £250,000 and £500,000. The approximate excess threshold is estimated at £100,000. Premiums can vary over time, adjusted according to the insurance cycle[6].

Mutual insurance

23. As the supporting study indicates, a mutual insurance scheme also entails the payment of a premium, although in effect only part of this applied to mutual assurance. The mutual assurance layer in the LAML model ranged from a baseline of £250,000 to a cap of £2m in the case of personal liability and £1m to £4m in the case of property, with claims above the capped values being re-insured using private insurers.

24. The fact that mutuals are non-profit organisations is considered the key means by which they can offer lower premiums compared to private insurers. According to its supporting feasibility study, the premiums payable by LAML participants were estimated to be between 15 per cent and 20 per cent below that offered by private insurers[7].

25. To establish a mutual, local authorities would be required to contribute to the costs of the feasibility study; set-up of the scheme; and, capitalisation. The more participants there are, the lower these costs would be for individual local authorities. Based on evidence drawn from the supporting study, a mutual scheme comprising 10 LA members could require a payment of £50,000 from each LA towards feasibility and set-up as well as a capital contribution of approximately £400,000. In addition, the internal staff costs of involved local authority staff would also have to be considered.

Advantages offered by private and mutual insurance

26. Essentially, the benefit of insurance is the value of risk being covered. In both the private insurance and mutual insurance schemes a similar range of risks are being covered. However, proponents of mutual insurance schemes have argued that these schemes provide an opportunity for improving risk management based on the lessons learnt from shared experience while proponents of private insurance schemes argue that these schemes are more resilient in respect of catastrophic events. For the purposes of analysing the key impact of the legislation, neither type of insurance is assumed to be more beneficial that the other.

What are the likely impacts of the proposed legislation on local government insurance?

Benefits

27. Private insurers and local authorities contacted as part of the supporting study have reported that there has been some significant discounting of premiums for local authorities since 2007. While some of the reduction might be attributed to downward movement along the insurance cycle, a number of consultees also expressed the view that at least part of the reduction could be the result of more competitive pricing on the part of private insurers, mindful of apparent interest on the part of some local authorities in establishing mutuals.

28. In effect, there is some evidence to suggest that the proposed legislation, by empowering local authorities to legally establish mutuals, will compel private insurers to continue to take into consideration the possible impact that their pricing policies may have on the apparent willingness of local authorities to develop their own insurance services.

[5] Defined as district councils and fire and rescue authorities.
[6] The tendency to swing between profitable and unprofitable periods over time
[7] However, establishing a mutual can also entail initial commissioning, procurement and capitalisation costs which were not necessarily in the feasibility study.

29. Therefore, although, the precise effect is difficult to quantify, it seems reasonable to argue that even if conditions in the financial markets are such that premiums increase, they will increase at a lower rate than that which would have occurred in the absence of potential competition from local authority mutuals.

30. If as a consequence of increased competition (or the threat of competition) in the local government market, the cost of total premia were reduced by just 1 per cent, this suggests that a total annual saving of between £3m and £6m could be obtained according to the estimated size of the total market as presented in the supporting study.

Costs

31. Whether, by enabling local authorities to establish mutuals, the legislation will actually lead to their re-establishment is difficult to predict. The study suggests that, while the experience of LAML's legal history may make some authorities wary of embarking on creating a new mutual, there are authorities who would be sufficiently interested if significant savings could be obtained.

32. Should local authorities decide to establish a mutual, they are likely to incur set up costs upwards the £500,000 mark depending on the actual number of participants. In addition, a mutual comprising 10 members could cost in the region of £4m to capitalise. However, consideration should also be given to the possible need for additional capital in the earlier, more financially vulnerable years, of a mutual[8].

Table 1
Establishment cost of a mutual and illustrative overall premia discount (1%)

	Establishment/ Year 1	Year 2	Year 3	Year 4	Year 5
Establishment Cost (£m)	4.5				
Annual Overall 1% Premia Discount (£m)	3 - 6	3 - 6	3- 6	3- 6	3 - 6
Cumulative Premia Discount (£m)	3 - 6	6 - 12	9 - 18	12 - 24	15 - 30

33. Nevertheless, should the establishment of a mutual yield a sustained 1 per cent overall reduction in the total cost of premia, Table 1 suggests that the initial establishment costs would be rapidly repaid if the aggregate cost of premia are considered.

34. However, in reality, the participants in an actual mutual scheme would be likely to require a premium discount of significantly more than 1 per cent to justify its establishment. Assuming that participants could obtain a premium discount of 10 per cent through setting up a mutual, Table 2 shows that a longer period of time would be required for actual participants in order to recoup their initial setting-up costs. Thus, while the global effect of increased competition may justify the establishment of a mutual, it is the extent to which *participants* benefit in particular that is key to whether one is actually created or not,

[8] The following analysis uses some key findings from the supporting study to illustrate the cost and benefits of establishing a mutual.

Table 2
Establishment cost of a mutual and illustrative premium discount for participants(10%)

	Establishment/ Year 1	Year 2	Year 3	Year 4	Year 5
Establishment Cost (£m)	4.5				
Annual 10% Premium Discount (£m)*	1	1	1	1	1
Cumulative Premium Discount (£m)	1	2	3	4	5

* Assumes 10 local authority participants originally paying £10m in premia to private insurers but achieve a 10% reduction in their premia through establishing a mutual

Summary of costs and benefits

35. In the time available to analyse the possible impact of the legislation, the available evidence suggests that by enabling local authorities to establish mutual insurance companies, the legislation should act to bring downward pressure on local authority premia. Given the estimated size of the local insurance market, summary analysis suggests that it would only take a relatively small overall change in the price of premia to recoup the cost of establishing a mutual.

Risk

36. As identified by the study, providing local authorities with powers to enter into mutual insurance arrangements presents some risk in the use of public money. Mutual insurance requires members to pool risk and, in effect, insure each other. The process of mutual insurance seeks to mitigate risk by spreading the risk wider than just the individual authority. The alternative to risk pooling is to contract that risk out to the private sector through the payment of an insurance premium which effectively spreads that risk much wider.

37. The participant authorities in LAML took the decision that the risk associated with pooling risk, as opposed to contracting that out, was of a significant scale based on past claim records that potential efficiencies of 15 per cent per annum were claimed.

38. A key principle of insurance is to spread risk through diversity across geographical, demographic and exposure types. To reduce their overall potential exposure, LAML re-insured the high level risk to ensure that any particularly extensive claims on the mutual did not have the potential to severely damage the capital base of the mutual. Risk mitigation strategies lie with the authority and the mutual to ensure that the potential liabilities and exposure is of an order which is acceptable.

39. The consultant's study noted that the scope for accumulation of reserves may be small or even possibly eliminated depending on the level of claims. This is something which local authorities will need to look at closely and develop a sound business case considering the past claims history of the participant authorities. The study also looked at Municipal Mutual Insurance (MMI), a local government mutual which was bought out in the early 1990's. According to the study MMI performed badly because it:

- expanded beyond its core business beyond local authorities and into non-insurance activities
- amended its governance so that it was not wholly local authority owned
- pursued poor investments which was heavily skewed towards commercial property at a time when the commercial property market was depressed
- had inadequate management and scrutiny – the regulatory regime and governance regimes in which MMI operated in were more benign than those that exist today

40. The legislation will ensure that the activities which local authorities can pursue are limited to core insurance services and only provided to its members. The governance structure is one which must meet FSA rules and requirements (see below). Communities and Local Government's view is that investments by the mutual should be made in accordance with the CIPFA guidance, *Treasury Management in the Public Sector - Code of Practice and Cross-sectoral Guidance Notes* which has statutory backing by virtue of regulations made under section 15 of the Local Government Act 2003.

41. Participating authorities may need to provide supplementary capital calls if the mutual requires greater capital reserves to meet FSA requirements. Local authorities must be prepared for this possibility and be able to identify how this extra capital would be raised without impacting on council tax or services before participating in a mutual. Possibilities include raising it either through existing revenue streams, or through a call on the authorities' reserves.

42. There are also risks associated with not intervening. As the study notes, the local authority insurance market has been reported to have softened over the past few years. This may be due to the increased competition due to the presence of LAML in the market, or could be due to the insurance cycle. Not providing local authorities with powers to enter into mutual insurance arrangements would remove a competitive edge in the local authority insurance market.

FSA regulation

43. The mutual would need to be authorised, supervised, and regulated by the FSA like any other insurer and subject to the same rules. This means that the FSA will be required to ensure that the mutual has enough capital in reserve which is currently €3.2m rising to €3.5m at the end of the year (with a 25 per cent discount for mutuals). The FSA would expect that at least this minimum level of capital would be subscribed by members up-front, but the exact amount of initial capital that would expect to be seen, would depend on the business plan and risk profile of the proposed mutual.

44. All non-life insurers are subject to a volume based capital requirement that the insurer should hold capital broadly equal to 27 per cent of gross premiums, or 39 per cent of claims incurred each year for liability insurance policies (or 18 per cent and 26 per cent respectively for other types of non-life insurance policy). These may be possible, upon application to FSA, that some of this capital requirement could be deemed to be covered by any claim which the mutual has by way of a call for supplementary contributions.

45. The mutual would also need to be established and operated in accordance with the FSA Handbook and comply with normal prudential and conduct expectations for commercially owned firms of similar size and risk profile. In particular, the mutual would need to meet all the FSA governance, risk management and reporting requirements and that the management of the mutual had appropriate and relevant skills and experience, and that the governance arrangements were appropriate, for a firm of that size and risk profile.

Discretionary mutuals

46. The study raised the issue on permitting local authorities to enter into discretionary mutuals and set out the benefits and disadvantages of such an approach. The main disadvantage of discretionary mutuals is that they are not regulated by the FSA. This means that the mutual would not be authorised, supervised, and regulated by the FSA and would not need to meet FSA requirements on governance, risk management and reporting requirements. There are also issues that payments from such a discretionary are based on agreements and may not be enforceable in law.

47. The Department's view is that when public money is used to provide mutual insurance to other local authorities it should be adequately regulated by an appropriate authority. Also, there should not be any scope for claims that payments are not enforceable. Whilst a discretionary mutual may have tax benefits, this does not appear to provide reason enough to risk public money through decreased regulation and non-binding agreements.

Consultation

48. The *Strengthening Local Democracy* consultation was published on 21 July 2009 and ran until 2 October 2009. It included a range of proposals to promote democratic renewal and strengthen the power and responsibility of local government. A full summary of responses to the consultation will be published later this year. However, in light of the proposed amendments to the LDEDC Bill a summary of the mutual insurance responses have been made available now.

49. In response to the question *"Should councils have a power to engage in mutual insurance arrangements?"* Ninety-six responses were received (as of 6 October 2009). Of those responses:

    - eighty-two per cent agreed with the proposed power (36 per cent also stated that they wanted a power of general competence for councils)
    - fifteen per cent were neither for or against and
    - three per cent were opposed.

50. One supportive respondent said, *"We believe this to be a sensible step, and any joint working between council's like this, that increases efficiency and value for money should only be encouraged"*. Others said, *"Whilst we support the introduction of a specific power to enable councils to engage in mutual insurance arrangements we also call for a power of competence for local government"*. Another noted, *"Extreme disappointment at the current barriers to continuing with Fire and Rescue Authority Mutual Insurance Initiative (FRAML) and would emphasise its view that powers to establish such bodies should be given to local authorities and fire and rescue authorities"*.

51. Respondents who did not directly support the proposal sought changes to, the well-being power or a general power of competence. One respondent said *"Just changing legislation to enable mutual insurance arrangements does not address the problems with the power of well-being (contained in the Local Government Act 2000) re-assessment of the terms of the well-being power would be more useful"*. Those opposed believed that undertaking mutual insurance arrangements was beyond the desirable remit of the local authority role.

52. The Department is still considering responses to the consultation about whether there are other similar arrangements – beyond mutual insurance – which councils believe could be

beneficial but which are potentially out of scope of existing powers. Once they have been assessed alongside other evidence the Government will decide whether further action should be taken.

Implementation arrangements

53. The policy will be implemented through the LDEDC Bill and through subordinate legislation emanating from that Bill. Many local authorities are already aware of the proposals through the high profile Court case concerning LAML but we will continue to work with the local government sector to ensure that authorities are aware of the contents of the proposals.

Enforcement arrangements

54. There are no specific enforcement measures in the proposals. The activity of insurance is regulated by the FSA and therefore any local authorities undertaking mutual insurance will fall under the enforcement and regulatory regime of the FSA.

Post implementation review/post legislative scrutiny arrangements

55. The Department will consider how the impact of the revised policy can be monitored and evaluated through its programme of local government research. Given the need to allow some time for the revised policy to take effect, such research is only likely to be scoped in future programmes.

Statutory impact test (race, gender, disability)

56. The mutual insurance power is a non-prescriptive enabling power and should not in itself have an adverse impact on race, gender or disabilities considerations. When making use of the insurance mutual powers, as part of their legal duty, local authorities should consider whether there are any such considerations that need to be addressed.

Competition assessment

57. Policy makers are required to consider if proposals will have a significant impact on competition by answering the four questions posed in the competition assessment. These are:

"In any affected market, would the proposal:

- *Directly limit the number or range of suppliers?*
- *Indirectly limit the number or range of suppliers?*
- *Limit the ability of suppliers to compete?*
- *Reduce suppliers' incentives to compete vigorously?"*

http://www.oft.gov.uk/shared_oft/reports/comp_policy/oft876.pdf

58. The proposal to provide local authorities with powers to participate in mutual insurance arrangements will:

- increase the number of suppliers in the local government insurance market by permitting local authorities to become active competitors in that market
- increase the number or range of suppliers
- provide greater competition by increasing local authorities' ability to compete in the market

- improve suppliers' incentives to compete vigorously by increasing competition

59. The impacts on competition were looked at as part of the independent study commissioned by the Department. It is arguable that the existence of LAML created a greater incentive for commercial suppliers to compete given the claimed lack of suppliers in the local government insurance market. Providing new powers to permit local authorities to re-enter the market should be considered to have a positive impact on competition.

60. The study also looked at, and expressed concerns about the potential for creating a dominant managing agent as much of the advice being provided to support local authorities have been developed by one company and there seemed to be little specific knowledge of the local authority sector beyond that company. The mutual insurance sector is broader that just those set up by local authorities, for instance, AMI has 36 members. Whilst these may not have specific knowledge about the local authority sector we would expect that once the level of demand increases, that the level of supply will also increase with skills, knowledge and experience brought in from other sectors to create a richer and competitive market.

Small firms impact test

61. We have considered the position on small firms and we do not consider that there is any impact.

Legal aid

62. We have considered the position on legal aid and we do not consider that there is any impact.

Sustainable development

63. We have considered the position on sustainable development and we do not consider that there is any impact.

Carbon assessment

64. We have considered the position on carbon assessment and we do not consider that there is any impact.

Other environment

65. We have considered the position on the environment and we do not consider that there is any impact.

Health impact assessment

66. We have considered the position on health and we do not consider that there is any impact.

Race equality

67. We have considered the position on race and we do not consider that there is any impact.

Disability equality

68. We have considered the position on disability equality and we do not consider that there is any impact.

Gender equality

69. We have considered the position on gender equality and we do not consider that there is any impact.

Human rights

70. We have considered the position on human rights and we do not consider that there is any impact.

Rural proofing

71. We have considered the position on rural proofing and we do not consider that there is any impact.

Specific Impact Tests: Checklist

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	No	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

Annex

Impact assessment of changes to legislation concerning local authority mutual insurance arrangements

Report for the Department for Communities and Local Government

LG Futures Ltd

September 2009

Contents

1. Introduction 18
2. Methodology 18
3. Costs and financial impacts 19
4. Alternative models 31
5. Comparable benefits 32
6. Comparable risks 34
7. Other information relating to public sector insurance mutuals 37

1. Introduction

1.1. One of Communities and Local Government's (CLG) key policy objectives is to encourage local authorities to undertake innovative shared services arrangements and to deliver significant efficiency savings. As part of that objective, the Department has consulted on proposals to undertake mutual insurance companies.

1.2. CLG officials note that it has been claimed that a guaranteed indemnity mutual insurance company could produce average savings in premiums; and, in addition, members of the mutual would share best practice, which would result in improved risk management, There is therefore some evidence that savings could be obtained by local authorities establishing and participating in a mutual insurance company.

1.3. In 2007, a number of London local authorities established a mutual insurance company, limited by guarantee, called London Authorities Mutual Limited (LAML). The establishment of LAML sought to offer efficiency savings to the individual local authorities and also to provide improved risk management services. However, a recent Court of Appeal judgment[9] ruled against the London Borough of Brent's involvement in LAML, prompting a call for clarification concerning the 'well-being power[10]' which it was believed allowed local authorities to participate in such schemes.

1.4. Thus, in parallel with a public consultation *Strengthening Local Democracy* the Department is exploring the possible financial impact of providing local authorities and their partners (e.g. fire and rescue authorities) with the power to establish and participate in a mutual insurance company.

1.5. In this context, in September 2009, the Department commissioned LG Futures Ltd. to undertake defined aspects of an impact assessment of potential changes in legislation.

1.6. Our instructions did not require us to consider alternative legal structures, such as the discretionary mutual, the captive insurance model or alternative approaches using joint committees. Our remit focused solely on the costs and benefits of a guaranteed mutual approach, akin to that used by LAML and the Fire and Rescue Authorities' Mutual (FRAML). However, we do note that the discretionary mutual model has potentially notable financial advantages, compared to the guaranteed mutual, and has been operating successfully in the university and higher education sector for over 15 years.

1.7 This short report summarises LG Futures' key findings.

2. Methodology

2.1 LG Futures' work was largely undertaken in the week commencing 21 September 2009, with the urgency of the task and the time available being constraints. Our views and findings necessarily reflect this limited timescale.

---

[9] On 9 June 2009.

[10] Section 2 of the Local Government Act 2000 provides local authorities with a 'well-being' power to take any steps which they consider are likely to promote or improve the economic, social or environmental well-being of their local community; although local authorities are expressly excluded, in Section 3 of the Act, from using this power to raise money.

2.2 Our methodology for undertaking this review was as follows:

- **Discussions with CLG officers.** We held initial discussions with the relevant policy officials within CLG to establish the overall limits of the review and maintained ongoing contact with Local Government Research Unit (LGRU) officials as the project progressed. Contact was made with other CLG officials as technical issues arose.

- **Desk-based research.** This involved the consideration of relevant literature available to us, including feasibility studies of mutual insurance businesses.

- **Key interviews.** Interviews took place (predominantly by telephone) with a range of stakeholders with expert knowledge of insurance issues, from London boroughs; county councils; district councils; fire and rescue authorities; insurance providers; managing agents; CIPFA; other mutuals; and a Scottish council.

- **Data assessment and evaluation.** This report contains a financial assessment of the potential impact of enabling mutual insurance entities. However, it is important to note that the information provided is based on an informed analysis of the available information, within the permitted timescales. The financial assessment should therefore not be regarded as a comprehensive forecast based upon detailed research.

2.3 The remainder of this report highlights LG Futures' key findings and associated conclusions.

3. Costs and financial impacts

Potential take up

3.1 In order to assess the financial impact of the creation of a local authority mutual insurance company, it is appropriate to firstly reflect on the scale of potential take-up amongst local authorities. The feasibility and option work that we have reviewed, undertaken by local authorities into mutual operations and alternative insurance models, indicate a range of outcomes. Our research found that, for fire and rescue authorities and some London boroughs, the guaranteed mutual model works; however, we also found that the Core Cities feasibility study was less encouraging owing, we understand, to the poor claims record of a large northern city.

3.2 The potential take-up is therefore seemingly influenced by the scale of authorities' perceived risks and their prior claim record.

3.3 We have also been informed, during the course of our interviews, that the development of the captive insurance company approach in Scotland was not carried through to

completion; and that this was due to the consequences of the insurance industry offering cheaper insurance to two large local authorities in Scotland, thereby making the proposal uneconomic. We are also aware of other feasibility studies[11] where the outcome is unclear.

3.4 Nevertheless, our interviews suggest that the fire and rescue authorities were, and still are, keen to implement a mutual insurance approach. It also appears that a number of the London boroughs would want to re-establish a LAML type model. Further, a trust involving 24 authorities[12] was in the process of being considered when the legal cases were decided. Consequently, this development has been put on hold. From the views we have elicited, it would appear that district councils generally perceive that they are too small to contemplate entering a trust individually. However, if clear savings were achievable, individual districts would consider joining into a trust arrangement managed by a larger organisation.

Size of the market

3.5 As far as we are aware, there is no official statistic providing the overall level of insurance expenditure across English local authorities and related bodies. However, our interviews suggest that larger[13] authorities typically spend £750,000 to £1m per annum, and smaller[14] authorities £250,000 to £500,000, on insurance premiums. Extrapolating these very broad estimates suggests an annual expenditure level of circa £300m on insurance by the English local authorities. A spreadsheet has been provided to us by Charles Taylor Consulting PLC projecting insurance expenditure based on authority type. The range of spending within this projection is narrower than we would expect[15]; however we believe using the midpoint for the insurance spend for English authorities may provide a reasonable expenditure figure - suggesting a national premium spend of £260m (ignoring parishes).

3.6 Other information we have reviewed suggests that overall expenditure might be higher than £260m. We note that financial forecasts for LAML indicate a higher average premium for each of the participating authorities. However, we have noted that the high spend of the Corporation of London distorts the average. In London, there is a different risk profile, which also distorts any forecast of average spend. The Bill Roots *Review of arrangements for efficiencies from smarter procurement in local government*[16] cites an expenditure figure of approximately £600 to £700m. For our purposes, an estimate of this order may be appropriate, with districts and smaller bodies spending about £150m and larger bodies about £500m.

3.7 There are suggestions from the advocates of the mutual approach that the take-up from larger authorities would grow from a small base to 25 per cent of the total market in a relatively short period (i.e. 5 to 10 years). This view is difficult to verify, although it is clear that the perceived successes of LAML had generated interest in many authorities. Nevertheless, if the current emphasis on the need for local authorities to make cost savings

[11] Such as for the county councils.
[12] 6 county councils, 7 unitaries and 11 Welsh authorities.
[13] For the purposes of our review, we have defined unitaries, metropolitan districts, London boroughs and county councils as 'larger authorities'.
[14] Defined as district councils and fire and rescue authorities.
[15] E.G. Birmingham MBC is much larger than Solihull, Essex is much larger than Rutland.
[16] CLG February 2009.

continues, it is inevitable that many authorities will explore new approaches and therefore take-up of a mutual insurance scheme could increase.

3.8 If the power for local authorities to form a mutual is granted, we suggest that, in the first five years, associated take-up could be up to 25 per cent of the larger authorities. However, this level of take-up would require market conditions to remain as they are; and assumes that the existing players i.e. commercial insurance companies, did not adopt effective defences to their market share.

3.9 Our research has uncovered some evidence that, in response to the establishment of local authority mutual insurance companies, private sector suppliers are likely to design new products and put forward new pricing structures. Therefore, we believe that the likely initial take-up by local authorities will be lower than the estimated 25 per cent[17].

3.10 However, we also note that there are precedents[18] in local government of new approaches being initially slow to establish; yet once accepted, these new approaches are adopted by an increasing number of authorities, and this could be the case for insurance mutuals. Therefore, it is feasible that take up could be higher than 25 per cent after five years.

3.11 In general, we believe the impact of the recent litigation, and the natural caution of members and Councils, suggests an incremental and steady growth if the legal barriers are removed. Indeed, in interviews, a number of the authorities contacted suggested that they will be wary of moving too quickly.

3.12 It should also be noted that the ability *to participate* in a mutual fund is not the only legal barrier facing local authorities. A number of interviewees were also concerned about current procurement law and the impact of the Teckal case[19] as well.

3.13 Tables 1 to 4, below, highlight possible insurance expenditure patterns arising from 'high' and 'low'[20] local authority participation in mutual insurance companies.

[17] We suggest a take up forecast of 10 per cent to 15 per cent is more likely. However, this forecast may be further reduced if the insurance companies reacted with vigour and offered targeted cost reductions to the larger authorities.

[18] For example the establishment of leisure trusts.

[19] This case set a precedent that under public procurement directives it is not compulsory to make a formal call for tenders even if the contracting party is an entity legally distinct from the contracting authority, where the contracting authority exercises a control over the entity that is similar to that which it exercises over its own departments; and the entity carries out the essential part of its activities with the local authorities that control it.

[20] 'High' and 'Low' are defined as up to 25per cent and up to 14 per cent respectively.

Suggested range of possible take-up rates under existing market conditions

Table 1: High projection using the Roots projections of spend

	Smaller LAs		Larger LAs			
	Number	%	Number	%	Total Insurance spend	Mutual Insurance 90% spend
Year 1	0	0%	10	5%	£28m	£25m
Year 2	0	0%	+10	10%	£55m	£50m
Year 3	0	0%	+10	15%	£83m	£75m
Year 4	0	0%	+10	20%	£110m	£100m
Year 5	0	0%	+10	25%	£138m	£125m

Table 2: Low projection using the Roots projections of spend

	Smaller LAs		Larger LAs			
	Number	%	Number	%	Total Insurance spend	Mutual Insurance 90% spend
Year 1	0	0%	8	4%	£20m	£18m
Year 2	0	0%	+5	6.5%	£32m	£29m
Year 3	0	0%	+5	9%	£44m	£40m
Year 4	0	0%	+5	11.5%	£56m	£50m
Year 5	0	0%	+5	14%	£68m	£61m

Note: Owing to current FSA regulations we estimate the first mutual would need to attract at least eight members otherwise the minimum capital requirements would be prohibitive.

Table 3: High projection using the Charles Taylor Consulting PLC projections

	Smaller LAs		Larger LAs			
	Number	%	Number	%	Total Insurance spend	Mutual Insurance 90% spend
Year 1	0	0	10	5%	£8m	£7.2m
Year 2	0	0	+10	10%	£16m	£14.4m
Year 3	0	0	+10	15%	£24m	£21.6m
Year 4	0	0	+10	20%	£32m	£28.8m
Year 5	0	0	+10	25%	£40m	£36.0m

Table 4: Low projection using the Charles Taylor Consulting PLC projections

	Smaller LAs		Larger LAs			
	Number	%	Number	%	Total Insurance spend	Mutual Insurance 90% spend
Year 1	0	0	8	4%	£6.4m	£5.8m
Year 2	0	0	+5	7%	£10.4m	£9.4m
Year 3	0	0	+5	9%	£14.4m	£13m
Year 4	0	0	+5	12%	£18.4m	£16.6m
Year 5	0	0	+5	14%	£22.4m	£20.2m

3.14 The LAML scheme included other insurance arrangements which are outside the scope of our review. For example, motor insurance represented about 10 per cent of the total LAML premiums. It is assumed that similar exclusions would apply for future mutuals. Hence our assumed restriction, in the above tables, to 90 per cent of the spend in total.

Costs involved

3.15 The following assumptions are primarily based on the information derived from the LAML feasibility study. However, we have sought to ameliorate any optimism bias by focusing on those LAML projections described as 'poor'. The LAML model was created by Charles Taylor Consulting PLC on the basis of worse than expected estimates and a higher level of claims. We have also had regard to the audited accounts of LAML to assess the reasonability of the models assumptions.

What are the likely set-up costs?

3.16 The set-up costs for the LAML model were estimated at £250,000. In addition, there was an estimated £160,000 payment[21] into the company, by each member authority, to establish the company's base capital to satisfy the requirements of the Financial Services Authority. We also found that a supplementary call for £1m capital was made in the first full year of LAML's operation, as a consequence of losses in one section of the business. Although this supplementary call was described in the documentation reviewed as a supplementary insurance premium, it is shown in the LAML statutory accounts as additional capital.

3.17 An assumption of £50,000 revenue costs for each authority involved to cover feasibility costs; appointment of advisers; meetings; establishment of new entity; recruitment of a board etc. does not seem unreasonable, based upon our experience of creating companies of a similar nature. Obviously, the greater the number of authorities joining, the more potential economies of scale that would arise; and if the mutual was for a smaller number of authorities, the costs would be proportionately higher.

3.18 The FSA required LAML to carry €3m cover as capital, which cost the LAML members £160,000 each. The current capital requirement for firms carrying on a liability business is €3.2m, rising to €3.5m at the end of 2009 (with a 25 per cent discount for mutuals). When Solvency 2[22] comes into force, the 25 per cent discount for mutuals will be removed: the FSA have suggested that the figure of €3.2m in the directive may possibly be increased to €3.5m by the European Commission. However, if the mutual is of a reasonable size, this minimum figure would be irrelevant, since the mutual would be required to have sufficient capital to cover its risks i.e. potentially a higher level of cover would be required.

3.19 For modelling purposes, we have assumed that each mutual would have a minimum of eight members. Therefore, the initial capital figure required would be €3.5m divided by 8, multiplied by an appropriate exchange rate[23]. The actual requirements are certain to change in future; however, for our purposes, we have assumed that future local authority members would need to contribute £394,000. We also believe an additional call for capital should not be disregarded from any projection; therefore, we have included an additional estimate of £400,000.

[21] See paragraph. 3.17.

[22] Solvency 2 is described by the Financial Services Authority as *"Solvency 2 is a fundamental review of the capital adequacy regime for the European insurance industry. It aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace the current Solvency 1 requirements."*

[23] We have assumed 1 Euro = £0.90.

3.20 In local government capital terms, if this initial payment is a loan, or a payment for shares, then it is classified as capital expenditure. However, for FSA purposes, we are advised that the initial payment is not a loan, nor is it a payment for shares, so arguably, this might be a revenue item. We contacted CLG's Capital Division for a view on the correct treatment; and the initial assessment we have received that the initial payments may not be capital for the purpose of local authority regulations. We suggest that this treatment is examined further. If the initial payment was a revenue cost, to be met out from one year's revenue income, then this would be a major financial obstacle to forming a mutual for many authorities.

3.21 For the purpose of the financial model, we have assumed that the capital contribution will be £400,000 per authority and that the annual minimum revenue provision (MRP) and interest on the capital sum will be 8 per cent i.e. £32,000 per authority. This would be a charge to the local authority's own general fund, and not the mutual fund, but the simple model shows it as if it were a mutual fund cost, in order to ease understanding.

3.22 The suggested set-up costs per authority are therefore as follows:

Table 3:

	Revenue	Capital
General set up prior to commencement	£50,000	£400,000
Year 1	£32,000	0
Year 2	£32,000	0
Year 3	£32,000	0
Year 4	£32,000	0
Year 5	£32,000	0
Total	**£210,000**	**£400,000**

Operational turnover and running costs

3.23 The operational turnover and the premiums received and paid could only be assessed fully by a detailed study of all local authorities participating in an actual mutual. The ability for a participating authority to enter into a mutual arrangement would be necessarily influenced by its existing arrangements and contractual commitments. In LAML's case, there was a phased introduction of insurance cover from the original participants over several years and this had not concluded by the time the legal judgements caused the business to close.

3.24 A group of local authorities could seek to run a mutual in several different ways:

- In LAML's case, a managing agent was procured who dealt with nearly all matters relating to the business, both insurance and administration. The managing agent's charges were approximately 5 per cent of the premiums paid.
- In UMAL's[24] case, an in-house team was established. We note that, potentially, this could be a cheaper option, as there would no VAT leakage and no profit to be paid; albeit, at the expense of more management and potentially higher risk.

3.25 In addition, there are governance costs, such as Director's payments and audit fees. Both these costs might increase as the size of the business grows, although in LAML's case, they were regarded as relatively fixed. For LAML, the Directors fees were approximately £50,000 per annum and the audit fees less than £20,000 per annum. For the purposes of the model, it is suggested that 0.5% of the premiums paid would be a fair allowance and this would broadly equate to the expenditure allowed for in the LAML case.

3.26 The operational turnover is based on the assumed participating authorities' share of relevant premiums; and also assuming that, in the first year, only 75 per cent of the premiums are received, as the arrangements are phased in from those that have existed previously.

3.27 The costs of claims and reinsurance are extremely difficult to predict. The claims paid vary in the model, reaching 30 per cent of premiums paid. The amount of risk laid off to other insurance companies varies between 50 per cent and 55 per cent of the premium costs. A cautious approach seems appropriate and, using the 30 per cent and 55 per cent of premium figures, should provide a buffer against optimism.

Table 5: High projection - Roots basis

	Premium income	Reinsurance	Claims	Management fee	Governance cost
Year 1	£18.75m	£10.30m	£5.62m	£0.84m	£0.08m
Year 2	£50m	£27.50m	£15m	£2.5m	£0.25m
Year 3	£75m	£41.25m	£22.5m	£3.75m	£0.37m
Year 4	£100m	£55.00m	£30m	£5m	£0.50m
Year 5	£125m	£68.75m	£37.5m	£6.25m	£0.63m

[24]The Universities and Higher Education Mutual.

Table 6: Low projection - Roots basis

	Premium income	Reinsurance	Claims	Management fee	Governance cost
Year 1	£14m	£8m	£4m	£0.7m	£0.07m
Year 2	£29m	£16m	£9m	£1.45m	£0.15m
Year 3	£40m	£22m	£12m	£2.0m	£0.2m
Year 4	£50m	£28m	£15m	£2.5m	£1.25m
Year 5	£61m	£34m	£18m	£3.05m	£1.52m

Table 7: High projection - Charles Taylor basis

	Premium income	Reinsurance	Claims	Management fee	Governance cost
Year 1	£5.4m	£3.0m	£1.6m	£0.3m	£0.03m
Year 2	£14.4m	£7.9m	£4.3m	£0.7m	£0.07m
Year 3	£21.6m	£11.9m	£6.4m	£1.1m	£0.11m
Year 4	£28.8m	£15.8m	£8.6m	£1.44m	£0.15m
Year 5	£36.0m	£19.8m	£10.8m	£1.8m	£0.18m

Table 8: Low projection - Charles Taylor basis

	Premium income	Reinsurance	Claims	Management fee	Governance cost
Year 1	£4.4m	£2.4m	£1.3m	£0.22m	£0.02m
Year 2	£9.4m	£5.2m	£2.8m	£0.47m	£0.05m
Year 3	£13.0m	£7.2m	£3.9m	£0.65m	£0.07m
Year 4	£16.6m	£9.1m	£4.9m	£0.83m	£0.08m
Year 5	£20.2m	£11.1m	£6.1m	£1.01m	£0.11m

Overall financial impact

3.28 The overall impact of the high take-up projection, using the Roots spend basis, suggests that, over 5 years, reserves of £17.85m could be accumulated by the mutual. On the low take-up projection, again using the Roots spend basis, reserves of £7.75m could be accumulated over the same time period. Even taking relatively conservative costs, the mutual projections suggest surpluses in every year, although there will be a significant financial vulnerability in years 1 to 3 when reserves are relatively small, especially where the lower level of take-up is projected. Such financial vulnerability gives rise to the possibility of further capital calls, as arose in the LAML situation. Such additional calls might need to be met out of revenue, unless they are regarded as capital expenditure for the purposes of the capital regulations.

3.29 If the Charles Taylor projections are used, the scope for accumulation of reserves is almost eliminated using even the higher take-up projections. Further, once the lower take-up projections are employed, in practical terms there appears to be no scope for generating surpluses. Therefore the use of mutuals, in these circumstances, would seem less than prudent because the opportunity to generate reserves to meet unexpected claims would not exist.

3.30 In addition to whether the mutuals can or cannot generate surpluses, it should be recognised that the participants would also be taking on additional risk. The incidence of claims can be erratic. Therefore, any reserves would need to be retained until such a time as the participants considered that it was reasonable to use some of potential surpluses to reduce insurance premiums. It is suggested that the reduction in premiums is unlikely in the early years of any mutual. It should also be noted that, within these overall projections, there are a number of separate mutuals. Inevitably, the results of individual mutuals may not be in accord with any general patterns that might be expected.

Table 9: Overall financial impact – High projection Roots basis

High projection	Year 1	Year 2	Year 3	Year 4	Year 5
Number of authorities	10	20	30	40	50
	£m	£m	£m	£m	£m
Premium earned	18.75	50.00	75.00	100.00	125.00
Reinsurance	10.30	27.50	41.25	55.00	68.75
Claims	5.62	15.00	22.50	30.00	37.50
Management	0.84	2.50	3.75	5.00	6.25
Governance and administration	0.08	0.25	0.37	0.50	0.63
Interest and repayment of loan	0.28	0.56	0.84	1.12	1.40
Set up costs	0.50	0.50	0.50	0.50	0.50
	17.62	46.31	69.21	92.12	115.03
Potential surplus	1.13	3.69	5.79	7.88	9.97
Accumulated surplus		4.82	9.48	13.67	17.85

Table 10: Overall financial impact – Low projection Roots basis

Low projection	Year 1	Year 2	Year 3	Year 4	Year 5
Number of authorities	8	13	18	23	28
	£m	£m	£m	£m	£m
Premium earned	14.00	29.00	40.00	50.00	61.00
Reinsurance	8.00	16.00	22.00	28.00	34.00
Claims	4.00	9.00	12.00	15.00	18.00
Management	0.70	1.45	2.00	2.50	3.05
Governance and administration	0.07	0.15	0.20	0.25	0.31
Interest and repayment of loan	0.26	0.47	0.59	0.74	0.90
Set up costs	0.40	0.25	0.25	0.25	0.25
	13.43	27.32	37.04	46.74	56.51
Potential surplus	0.57	1.68	2.96	3.26	4.49
Accumulated surplus		2.25	4.64	6.22	7.75

Table 11: Overall financial impact – High projection CTC basis

High projection	Year 1	Year 2	Year 3	Year 4	Year 5
Number of authorities	10	20	30	40	50
	£m	£m	£m	£m	£m
Premium earned	5.40	14.40	21.60	28.80	36.00
Reinsurance	3.00	7.90	11.90	15.80	19.80
Claims	1.60	4.30	6.40	8.60	10.80
Management	0.30	0.70	1.10	1.44	1.80
Governance and administration	0.03	0.07	0.11	0.15	0.18
Interest and repayment of loan	0.28	0.56	0.84	1.12	1.40
Set up costs	0.50	0.50	0.50	0.50	0.50
	5.71	14.03	20.85	27.61	34.48
Potential surplus	-0.31	0.37	0.75	1.19	1.52
Accumulated surplus		0.06	1.12	1.94	2.71

Table 12: Overall financial impact – Low projection CTC basis

Low projection	Year 1	Year 2	Year 3	Year 4	Year 5
Number of authorities	8	13	18	23	28
	£m	£m	£m	£m	£m
Premium earned	4.40	9.40	13.00	16.60	20.20
Reinsurance	2.40	5.20	7.20	9.10	11.10
Claims	1.30	2.80	3.90	4.90	6.10
Management	0.22	0.47	0.65	0.83	1.01
Governance and administration	0.02	0.05	0.07	0.08	0.10
Interest and repayment of loan	0.28	0.56	0.84	1.12	1.40
Set up costs	0.50	0.50	0.50	0.50	0.50
	4.72	9.58	13.16	16.53	20.21
Potential surplus	-0.32	-0.18	-0.16	0.07	-0.01
Accumulated surplus		-0.50	-0.34	-0.09	0.06

What is the potential for savings?

3.31 In 2006, the feasibility studies for both LAML and FRAML indicated the potential for generating savings of between 15 per cent and 20 per cent. Since then the local authority insurance market has softened and price reductions of between 20 per cent and 25 per cent have been reported. These price reductions were confirmed in our interviews with local authorities and the commercial insurance suppliers. However, we cannot confirm that, in 2009, further scope exists for additional price reductions.

3.32 The tables in this report demonstrate the possibility of the accumulation of surpluses in any mutuals that are being formed. We believe any surpluses should be ignored[25] for the purposes of any potential savings assessment; as they ultimately represent contributions to a reserve fund, which will be required to allow the mutual to meet any future claims. It is only when the reserve fund has a substantial amount of reserves, that a 'prudent' mutual could deem reasonably appropriate, that an opportunity will exist to reduce the premiums for member authorities.

3.33 However, the evidence obtained during our review provides a strong indicator that where local authorities have been motivated to develop initiatives such as FRAML and LAML, as well as the proposal for a captive insurance company[26]; the commercial insurance providers have reacted by offering more keenly priced solutions to protect their current market shares. Therefore, at the very least, an ability to create guaranteed insurance mutuals should help local authorities to secure cost effective future commercial insurance rates.

[25] At least in the early years of any mutual's formation.
[26] Promoted by a number of Scottish local authorities.

4. Alternative models

4.1 As part of our review we have also considered the alternative models of self-insurance and external procurement of insurance.

Self insurance

4.2 The mutual model examined above includes self-insurance, as the LAML model allows a minimum £100,000 excess against claims. It is widely reported that local authorities have increasingly taken up self-insurance, in order to accept perceived low risk and minimise cost[27]. In cost terms, self-insurance can be economic, but is also risky, especially for smaller organisations, and, unless organised on a national or regional scale, it appears to be unattractive, as even the largest authorities cannot afford to take the level of risks involved.

4.3 Of course, central government currently self-insures and it might be cost effective if all local authority insurance premiums were paid into a central pool and claims dealt with from this pool – as they are for NHS medical litigation. However, we believe, for the purposes of this exercise, although self-insurance might gradually increase, it is unlikely to be a candidate for many authorities.

External insurance

4.4 The insurance market is cyclical and, depending upon economic trends, there will inevitably be periods when prices fall and periods when prices increase. Currently, prices appear to be falling - we have previously noted that there is a general acceptance that prices have decreased by between 20 per cent and 25 per cent over the past two years[28].

4.5 These overall prices are difficult to compare with LAML, as they are fixed price i.e. based on a definite premium amount and regardless of the number of claims that are subsequently attached to the policy. Once the premium is paid, risk has transferred. For LAML, a poor claims experience could mean a call for additional funding on prior years.

4.7 The prices paid by customers can, of course, increase as well. The industry interviewees suggested that pricing pressure will emerge over the next few years, as insurers are affected by the same economic environment as everyone else. This means the cost of capital will rise as investment income drops. This is just as likely to be true of a mutual of course, but their source of funding is far more limited.

4.8 Based on the opinions and views that we have encountered, the evidence suggests:

- The local authority insurance market has a limited number of players and dominant companies (for example, Zurich Mutual and RMP) and, historically, there have been areas of the UK where there was an ineffective market and one company was active. This situation has not been highlighted as a current issue.
- Insurance prices have fallen in recent years and are continuing to fall.

---

[27] For example, Birmingham's self-insurance fund has been expanded to reflect additional areas beyond employers' liability, which had been covered for many years.

[28] Individual authorities will obviously have received larger and smaller reductions, dependent upon a variety of factors, including the timing of the tender.

- The existence of mutuals, or even the contemplation of the formation mutuals or equivalents, has resulted in market redesign and keen pricing. This has occurred both in Scotland and in London.
- The development of group purchasing or consortia approaches for procurement has the possibility to secure even lower insurance prices.
- The LAML and FRAML models suggest that, in 2006, discounts of between 15 per cent and 20 per cent could be offered, compared to commercially procured policies. Any entity that does not seek to make profit potentially has a lower cost base than one that does, but given the hardening of the marketplace and lowering of insurance prices, the ability to generate price reductions of 15 per cent in the current marketplace might be challenging. It was reported to us that former members of LAML, having now secured savings, might reassess the benefits of joining any new insurance mutuals as they now have the savings they were seeking.
- If the legislation were established to allow mutuals, the industry would be expected to react strongly to protect its position. Consequently, situations where large local authority players were offered special deals might be expected to arise, as it did in Scotland, when the authorities considered setting up a captive insurance company.

4.9 Overall, local authorities having the power to enter into a mutual for insurance purposes has an impact on market pricing. That impact has been seen to lower prices and create a reaction to existing pricing and business arrangements. The creation of mutuals would be lower if the local authorities could secure lower prices from the private sector insurance market.

5. Comparable benefits

5.1 We have listed, below, what we consider to be the major comparative advantages and disadvantages of a guaranteed mutual compared to commercial insurance.

Advantages of a guaranteed mutual

Control and information sharing

5.2 The members have control of their insurance. This means that they can determine pricing, cover and services and ensure that good practice is developed across participating authorities.

Independent regulation

5.3 They are regulated by the FSA and must meet the usual solvency and regulatory standards.

Increased market size/choice/competition

5.4 The mutual will introduce additional players into the insurance market and competition might increase.

Retained surpluses

5.5 Any surpluses can be re-invested or returned to the members, but risks will be taken and losses could arise.

Smoothing of prices

5.6 The insurance pricing is often difficult to foresee and therefore plan for. A mutual approach may allow smoothing to take place.

Availability of cover

5.7 There is a view that, as a mutual is owned by its members, there will be access to a wider, more flexible range of covers, especially for difficult to cover issues.

Better recognition of risk management successes

5.8 Bodies with a good claim record will be able to join mutuals and secure price reduction. Poor claim records and high risk situations may force local authorities to buy from the market and they may have higher costs.

Efficiency

5.9 It can deliver savings and reflect a collaborative approach.

Ownership of risk data

5.10 A mutual should ensure that data will be more freely available.

Perceived disadvantages of a guaranteed mutual

Potentially creating a dominant managing agent

5.11 The mutual management and much of the advice being provided to support local authorities have been developed by one company. We are uncertain what capability there is in the market for alternative suppliers. There would appear to be too few organisations with the local authority specific knowledge that could do this.

Risk accumulation

5.12 A key principle of insurance is to spread risk through diversity, including geographical, demographic and exposure types. Mutuals might be geographically based and accumulate risk in one area. Issues such as storm, flood or terrorism could have an undue impact on the arrangements.

Unexpected high losses

5.13 Unusually high losses in the early years would deplete a mutual fund and could require a significant call for extra funds. This occurred in the LAML case and an additional cash call of £1m was required.

Value for money

5.14 All public sector organisations should be able to demonstrate value for money and the mutual models need to establish a framework for doing this, at both overall mutual and individual authority level. Commercial insurance is a transfer of risk for an agreed premium that is fixed for the insurance year, regardless of the claims that occur.

Impact on non-members

5.15 Mutuals will vet new members carefully. Authorities with poorer risk records will have to insure commercially and they can expect higher premiums.

Officer and member involvement

5.16 With the number of competing priorities that local authorities face, the responsibility of running of insurance mutual may be seen as unnecessary, given that it is not a core service.

Impact of poor performer

5.17 With a small membership, there is far greater potential for the deterioration in the risk of one member impacting disproportionately on the others. Taking on the risks of others could be difficult for local authorities.

Access to data pool and risk experience

5.18 A mutual will have good access to its own knowledge, but restricted knowledge across other organisations.

6. Comparable risks

6.1 The guaranteed insurance mutual models are an illustration of the make or buy decisions that organisations have to consider i.e. do we provide our own insurance scheme or do we procure one from the market place? Insurance is not a major activity for a local authority and certainty not a core activity. Establishing a mutual effectively involves a local authority taking more risk, in exchange for potentially lower insurance costs and a more tailored service.

6.2 The key risks that we perceive are:

Risk	Mitigation	Cost
The financial projections underestimate the amount of claims and substantial addition contributions have to be made into the mutual fund. If insurance is purchased from a commercial company, this risk does not fall to the local authority.	The business cases and the financial management of risk should ensure that major risks are laid off by way of reinsurance. Entry into the mutual ensures only those local authorities with a good track record can be permitted to join	The predicted claims are factored into the business case, but in the early years of a mutual, there is a risk that high claims could emerge and this would give rise to unexpected calls for additional capital. The local authority members

Risk	Mitigation	Cost
		may or may not have the available resources to meet such liabilities
The risk of further litigation and dispute. If insurance is purchased from a commercial company, this risk does not fall to the local authority.	Whilst any legislation may seek to remove any uncertainty, there are legal issues that have been subject to litigation that remain e.g. procurement law and Teckal related issues. The insurance industry has shown a willingness to challenge local authorities in the courts and there is no obvious way of ruling out the possibility completely.	Litigation is costly and no insurance cover can be put in place. Whilst any risk of litigation exists, caution will be needed to secure the establishment of mutuals and they will increase set-up costs.
The distraction of management away from core issues causing poor decisions elsewhere. If insurance is purchased from a commercial company, this risk does not fall to the local authority.	The business cases must place emphasis on the need for good management both for the mutual but regard should be made to the consequences to the authority.	A difficult issue to quantify, but the governance procedures of local authorities should ask the question and ensure that the extra governance effort can be taken on with no undue risk.
Poor risk management arrangements inside the insurance mutual give rise to unexpected losses and financial risks. It is assumed that a LAML approach would be followed with three tiers of risk being consider (tier 1 – self-assurance; tier 2 – mutual but with a cap & then reinsurance; tier 3 – catastrophic risks are reinsured). If a mutual did take on unreasonable levels of risk that would be a major	The employment of insurance experts provides comfort, but it is not clear how client management of their performance can operate when there is little internal expertise. The FSA regulation should give high level assurance of	CLG might consider the development of a professional code and look for a form of self- regulation. The costs of that regulation might be paid for by the participating local authorities.

Risk	Mitigation	Cost
issue and could cause deficits. If insurance is purchased from a commercial company, this risk does not fall to the local authority.	management, but this is likely to be retrospective.	
The FSA regulation framework for insurance entities requires increasing levels of capital and the detailed operation of insurance businesses is subject to much greater regulation. If insurance is purchased from a commercial company, this risk does not fall to the local authority.	The regulation framework is likely to get tougher. The period of self-regulation previously favoured has passed now we have had the credit crunch.	The business cases must allow adequately the impact of regulation.
Budgetary pressures within the local authority could prevent the acceptance of higher charges needed to keep the insurance mutual solvent. If insurance is purchased from a commercial company, this risk does not fall to the local authority.	Good governance arrangements supported by peer reviews and possibly compliance with a self-regulatory code of practice.	This should be an integral part of running a good business, so there should be no additional costs.
Too much reliance on a single firm to provide managing agent service – it appears Charles Taylor Consulting PLC is the only known provider	The work should be put out to competition but, without there being an established market for managing mutuals, it is not clear whether the competition would be effective.	Ineffective competition can lead to high prices and poor service.
Municipal Mutual Insurance (MMI) failed because of the following: 1)Expanding beyond its core business beyond local authorities and into non- insurance activities 2) Amending its governance so that it was not wholly local authority owned.	All these areas are at risk and it is suggested that CLG consider: 1) Limiting the scope of the business activities 2) Defining where investments might be	The costs of going out of business are significant and safeguards need to be established.

Risk	Mitigation	Cost
3) Poor investments - MMI's investment portfolio was heavily skewed towards commercial property at a time when the commercial property market was depressed. 4) Inadequate management and scrutiny – the regulatory regime and governance regimes in which MMI operated in were more benign than those that exist today.	placed 3) Looking for FSA and perhaps a self-regulation code to provide assurance	
A reinsurer going out of business leaving the mutual with no way of meeting any outstanding claims,	Due diligence exercises before policies are taken out. This risk exists whether or not there is a mutual put in place and is not a new risk.	Ongoing and normal insurance risk.

7. Other information relating to public sector insurance mutuals

Municipal Mutual Insurance

7.1 At the turn of the century, local government provided much of the power and water and ran public transport, as well as delivering many of the services that we have today. If a need required fulfilling, local government had the confidence, and seemingly the legal power, to do so. Municipal Mutual Insurance (MMI) was formed in this era, in 1903, by a group of UK local authorities in response to what was seen as an ineffective insurance market and one which was considered expensive.

7.2 Following local government reorganisation in 1974, over 90% of the UK public entities had placed some form of insurance with the mutual and a majority had placed all their covers with it. However, in 1992, the mutual went out of business. The key reasons for MMI's failure demise are outlined in 6.2 above.

Universities and Higher Education

7.3 UMAL is a dedicated Higher Education and Further Education specialist insurer. Formed as a mutual organisation by four universities in 1992, its membership stands at 63, encompassing both large and small institutions in the UK's Higher Education and Further Education sector. We understand that it is not regulated by the FSA, as it is a discretionary

mutual; as such, it has a range of advantages and disadvantages compared to other structures. For example, it does not offer insurance, but 'protection', and therefore no insurance premium tax is paid. Further, it cannot offer insurance which is mandatory, employers' liability, for example; and payments out of the mutual are made on the basis of agreements which may not be enforceable in law. We are advised that UMAL has been used as the model for other such mutuals e.g. liveries mutual.

7.4 UMAL is owned, managed and dedicated to delivering effective cover and solutions to risk for our members – and sharing information and spreading best practice in areas such as risk management. UMAL self-funds a substantial proportion of risks, and utilises traditional and new insurance market opportunities.

7.5 UMSR is a separate mutual (UMSR), focusing on providing cover on special risks such as terrorism. Formed in 1993, UM Association (Special Risks) Ltd (UMSR) commenced business with 29 member institutions across the UK's Higher Education sector. Since then, its membership has increased to include 110 leading universities and colleges seeking effective terrorism cover.

7.6 UMAL and UMSR assert that they can demonstrate savings to their members well in excess of £50m; and they represent the most successful example of shared services that the university and HE sector has produced. For example, we were informed that UMAL has returned over £15m to its members since 1992; and that it currently holds £16m in reserves (member's funds), excluding claims reserves. This is without estimating the benefits to the sector as a whole of other providers having to revise their pricing and improve services to compete with the mutual. As might have been expected, the transfer of so much business away from profit making commercial businesses created much opposition.

7.7 A recent independent survey of its members indicates that the level of service standards UMAL provides has been confirmed as being excellent. This includes risk management services. The cover wordings have continually improved, beneficially for members, to meet exposure developments within the higher education sector.

7.8 A large loss was sustained in 2005. Indeed, this was the largest loss ever in the Higher Education sector and was the largest[29] that year in the UK, for a single entity. The UMAL Board exercised their discretion, accepted the claim and agreed settlement in January 2009. Interim payments were made along the way to support the university.

Fire and Rescue Authorities (FRAML)

7.9 In September 2007, the Fire and Rescue Authorities Mutual (FRAML) commenced operation. It was widely welcomed within local government as a means to deliver efficiencies through effective collaboration. It stopped business after seven months, when the powers contained in section 5 of Fire and Rescue Service Act 2004 were deemed inadequate to provide the vires for what had been done.

[29] With the exception of the Buncefield oil storage depot fire in December 2005.

Initial five participating members

- Royal Berkshire FRA
- Cheshire FRA
- Devon & Somerset FRA
- Hampshire FRA
- Kent & Medway Town FRA

New Members

- Bedfordshire & Luton FRA
- Cambridgeshire & Peterborough FRA
- Essex FRA

7.10 David Howells, chair of FRAML, told us *“Just prior to the legal challenge by RMP there was a growing interest and appetite in the public sector in mutuals. [I know that in the case of fire and rescue authorities I fully expected most of the 24 combined fire and rescue authorities to join - we had nine members signed up at the time of our demise]. There was considerable interest I believe amongst district councils and police authorities….”*

7.11 Mr Howells also cited the following benefits of a mutual:

“Savings in premiums. *For example FRAML was able to offer an average of 15% saving on premium costs - and FRAML generated a significant operating surplus after just seven months' operation. By way of example after management costs have been offset our (Hampshire FRS) share of this is likely to be about £70k. Small figures, but you need to remember we are relatively small authorities.*

Competition. *We have evidence that the very existence of FRAML (and LAML) meant that insurance companies were offering lower premiums to all fire and rescue authorities in an attempt to dissuade them from joining the mutual. We were a competitive challenge.*

Remember too, that mutuals still use the conventional marketplace to obtain reinsurance (for layers of risk that are deemed to be too much for the mutual to bear).

A mutual encourages a better attitude and better practices at risk management within authorities. None of our members wanted to let the side down! We shared good practice.”