A 'new world' order

Local authorities are now operating in a 'new world' of increased financial risk to their insurance funds as the so-called compensation culture sees claims rise. **John Birkenhead** reports on the strategies being employed to deal with this.

Digital Vision

INSURANCE is a very difficult area for local authorities. As compensation claims rise at around 15% a year, insurers are restricting the amount of cover offered by increasing deductibles and aggregate limits. Few insurers will underwrite local authority business, which means there is little scope for such organisations to 'shop around'.

Claims to authorities have increased rapidly in several key areas. Highways claims — for example, trips and slips on pavements — cost local authorities over £150m each year in compensation — three times that of 10 years ago. The cost of school fires has doubled over the past five years, reaching a record high of almost £100m in 2002. Flood and storm damage claims in 2002 cost the public sector 50% more than in 2001, reaching a record high of £22m, almost four times the average annual cost over the last decade.

An increasingly difficult issue

Claims not covered by the authorities' insurance are paid for out of their insurance fund. Typically, a fund's liabilities are in the range of £5m-£10m. How much money to set aside for incurred but not reported and future claims is becoming an increasingly difficult issue for authorities in the current challenging environment of increasing claims and extreme pressure to stay within local spending budgets.

However, it is not just the issue of funding ever-higher self-insured claims that increases the financial risk to authorities. There are more subtle impacts that need to be recognised. These include being uninsured for 'extreme' events such as flood/storm claims (such claims can easily cost £250 000). There is also increased volatility in the actual claims out-turn from one year to the next, as large claim events now have a much greater impact. In addition, fund surpluses are less 'spendable' — for example, to spend on risk management initiatives — than before, and there is the need for funds to be kept back for a 'rainy day' rather than spent.

To better forecast the likely future claims out-turn, more and more authorities are turning to independent actuaries. These typically seek to obtain detailed data in order to identify and quantify claims trends — for instance, how the claims have been reported and settled, the estimated value of the claim throughout its life and so on. Unfortunately, the quality of claims data held by authorities is typically poor, usually consisting of a 'claims listing', merely showing a 'snapshot' of all claims at the valuation date.

In an extreme case of poor data, an actuarial opinion was refused for one London borough until better data was obtained. This new information revealed a multi-million-pound deficit in the insurance fund, in an extremely challenging budgetary framework. The latest audit commission report *Stewardship and Governance*, confirmed the view that: "Local authorities are in danger of suffering the consequences of mismanaged finances, and making decisions based on weak data."

For one authority in the South-east, the takeover of additional liabilities from new council areas, the floods in 2000/2001 and the impact of claims management companies triggered a full actuarial review. The review recommended that a longer-term view of the fund contributions be implemented — for example, funding for a major flood claim at least once every five years, thus stabilising the contributions from year to year. In addition, the review highlighted the poor quality of data from the incoming council areas (thus generating uncertainty over the amount of liabilities that had actually been transferred). It also set out what data should be collected in the future and showed how it could be used by the authority to track trends in the data itself.

Deteriorating claims experience

Another authority, this time in Scotland, waited three years to have a fund review updated. This update showed that the fund's deficit had doubled in just three years, due to rapidly deteriorating claims experience. This decline could have been identified and early warnings sounded just one year after the original review had the authority collected the data and had an appropriate analysis framework.

With such increased financial risks, authorities should not wait for three years for each actuarial review of their insurance fund (as is commonly the case with authorities' pension funds). Annual insurance fund reviews are becoming more important — and more common — in order to give early warnings that can be acted on.

Furthermore, a more long-term view needs to be taken of the future claims experience. Whereas in the past, a 'bad' year may well have been covered by insurance, now it may not be. Authorities should now aim to fund for these 'bad' years. By taking too short-term a view, local authorities may not accumulate enough funds in the 'good' years to pay for the 'bad' ones. But taking a long-term view requires detailed data about the trends of past claims in order to frame assumptions about those likely to arise in the future.

With the increased volatility in claims from year to year, 'surpluses' in authorities' insurance funds may not be as 'spendable' as they used to be. **Post**

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