In this provocative article, John Birkenhead, actuary to a number of local authority insurance funds, challenges the conventional insurance-buying pattern of local (and police) authorities. He argues that most authorities are probably over-insured, leading to opportunities for substantial premium savings in these cash-strapped times.

ARE YOU Over-Insured?

As public bodies, local (and police) authorities are exempt from buying normally 'compulsory'classes of insurance, such as employers' liability and motor third party. So, why then, do authorities typically buy numerous policies each year (employers' liability, motor third party, public liability, property, personal accident, etc.), spending perhaps over £1m per year on external premiums? Furthermore, why should policy deductibles vary so widely, with perhaps up to £1m excess per claim for liability but ground-up cover (nil excess) for personal accident, travel, school journey, etc?

The most fundamental purpose of insurance is to protect the authority's balance sheet/revenue account from 'excessive' claims across all classes in a given year, with more 'normal' volatility from year to year being covered by robust contribution rates. The relevant questions are then:

- What events could give rise to 'excessive' claims, either from a single class of business or across a number of classes at the same time (e.g. an explosion in council offices/ properties)?
- What would be the total annual cost of all such events (expected maximum losses)?
- What pre-loss risk management can reduce the frequency of such events?
- What post-loss event control is in place (e.g. business continuity plans) to reduce the severity of such events?

Once the effectiveness of the authority's risk management of such events is understood, the level of risk (annual aggregate limit/catastrophe stop loss limit) which it is comfortable in retaining across all classes of business can be agreed, allowing for any potential (limited) recoveries for non-insurable emergency expenditure under the Bellwin scheme. The key point is that the authority only needs financial support in a 'bad' year overall, not if a 'bad' year for property claims has been offset by a 'good' year for, say, liability claims.

Insurance is one risk financing option but with additional transactional costs, such as insurance premium tax. Another option is catastrophe bonds, which typically pay out a fixed amount in the event that the bond's 'index trigger' (e.g. a rise in the level of the River Thames during a flood) is exceeded. Such bonds are not indemnity policies (thus, there is a potential mismatch in the authority's actual claims versus the bond payout) but they are widely used in the private sector (e.g. for severe windstorms).

Further, risk pooling is used by other public bodies, such as NHS Trusts (who contribute to the NHSLA pool, which is a pay-as-you-go arrangement and, thus, each Trust is not guaranteeing the liabilities of others, a key point in the recent London Authorities Mutual Limited (LAML) judgement).

The 'public body' exemption from compulsory insurance means that most authorities are probably over-insured; financial protection is only really required across all classes combined (i.e. aggregate/ catastrophe stop loss protection) and may not be best provided under a traditional insurance policy.

This does require a change in the authority's cultural attitudes towards such financial protection - under a catastrophe stop loss policy, the authority would be expected to recover perhaps once every 10 to 20 years, rather than having some claims paid each year (with even some small claims paid in full) under current sub-optimal risk financing structures.

In these stretched economic times, authorities should be carrying out fundamental reviews of their insurance programs to maximise the value of external risk financing costs. ■

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