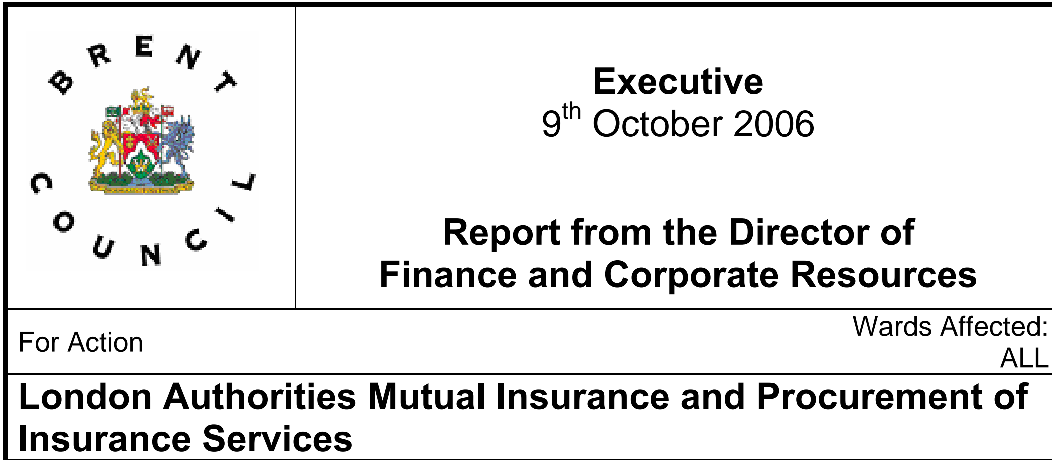
ITEM NO: 11



Executive
9th October 2006

Report from the Director of Finance and Corporate Resources

For Action	Wards Affected: ALL

London Authorities Mutual Insurance and Procurement of Insurance Services

Forward Plan Ref: F&CR 06/07-20

1.0 Summary

1.1 This report describes the proposal to establish a "Mutual" insurance company controlled by, and run for the benefit of, participating London authorities. They would pool their risks and the costs of administration, whilst retaining the current levels of self-insurance. The Mutual will reinsure high-level risk and issue policies to its members annually. It will register with the Financial Services Authority as an insurance company and it will need to capitalise (by guarantees from member authorities) and appoint experienced non-executive directors as well as London Finance Directors to ensure it was run appropriately.

1.2 The Mutual is likely to generate economic and other knock-on benefits from financial savings and improved risk management.

1.3 Participating authorities will be full members. The Mutual will be run by a board of directors comprising of directors appointed by the member authorities and a minority of independent directors.

1.4 The report therefore asks for approval to explore further the option of joining the proposed Mutual. Officers will report back to the Executive once the options have been explored further and legal advice has been obtained. It also asks for approval for the carrying out of a tender process in parallel with examination of the Mutual, should the Mutual proposal not proceed or not be ready to issue insurance contracts by 1st April 2007.

2.0 Recommendations

2.1 The Executive agrees in principle to participate in the Mutual but subject to receiving a further report back from officers once they have fully explored this option and once external legal advice is obtained.

2.2 The Executive notes that the proposal is that the Council would become a full member of the company and would agree to purchase Brent's corporate Property, Liability and Motor insurance requirements for a minimum period of one year through the Mutual with effect from 1st April 2007. In the event that the Mutual is unable to assume risk by that date the Council would obtain interim cover through the tendering process described below.

2.3 The executive further notes that the proposal also is that the Council would participate in capitalising the company by way of a financial guarantee of no more than £1m.

2.4 The Executive gives approval to officers to the inviting of tenders for insurance services as an alternative to joining the London Authorities Mutual on the basis of the pre-tender considerations set out in sections 3 – 5 of the report and gives approval to officers to evaluate tenders on the basis of the evaluation criteria set out in section 5 of the report.

3.0 Detail

3.1 Introduction

3.1.1 A steering committee of London Treasurers, assisted by working groups of London Borough Risk managers, and acting through the London Borough of Croydon, has been evaluating a proposal to create an insurance mutual. The project has been supported financially by the London Centre of Excellence (LCE).

3.1.2 An insurance mutual is a joint venture controlled by its members. The members insure with the mutual, instead of with commercial insurers, and they pool risks and share costs.

3.1.3 The steering committee and the LCE commissioned Charles Taylor Consulting PLC (CTC) to carry out a feasibility study using data from 26 authorities - London Boroughs, the City of London and the GLA. CTC reported that a mutual would offer its members savings of between 15% and 20% on average on insurance premiums for liability and property insurance and accumulate surpluses between £8.3 million and £15 million over the first five years of trading. The surpluses would be available to members and could be used to reduce premiums further.

3.1.4 In part, this saving reflects the cost sharing characteristics of a mutual. In part, it reflects the weakness of the current market for local authority insurance.

3.1.5 A mutual offers this authority advantages over and above reductions in annual premium. Underwriting profits are retained for the benefit of the members of the mutual, not paid away to third party shareholders. The financial incentives to make an underwriting profit enhance the value of and rewards the risk management endeavours of this authority. A mutual offers this authority the opportunity to determine underwriting appetite and develop policies which are focused solely on and meet the needs of local government in London. A mutual structure offers the prospect of greater pricing stability and will attract support from sectors of the reinsurance industry who would not entertain individual local authorities. A collaborative endeavour across London Boroughs links in with the agenda to maximise cost efficiencies and with the National Procurement Strategy of collaborating in the purchase of services. Other groups of authorities in the country are also considering establishing similar vehicles.

3.1.6 Brent currently insures the bulk of its policies with Zurich Municipal. Previously the Council insured with Royal Sun Alliance. The total annual cost of premiums in 2006/07 was £1,211k. This contract was competitively tendered and the service began on 1st April 2002. Only two full tenders were received in that exercise reflecting the weakness of the local authority market.

3.1.7 The current insurance arrangements are a mixture of retained losses (self insurance) and external insurance coverage. The program has three elements of cover comprising of property, liability and other risks primarily motor insurance. The essential difference in the covers is that property and liability carry significant excesses and losses under the excess level are retained (self insured). Motor and all the other miscellaneous covers have very small excesses and all the risk is placed in the insurance market. The current levels of excess applying to the property and liability covers is £278k and there is an aggregate stop loss protection of £3,481k. The effect of the aggregate stop loss protection is that the cover applies to all losses sustained in any one year up to the stop loss level. Losses in excess of this figure are then fully insured and this provides protection by way of a known ceiling of possible expenditure in any financial year. This configuration has been in place since 1994 and because the program has been in place for a long period the loss figures provide excellent data to help predict future loss patterns.

3.1.8 In the period since 1994 there has only been one recovery from Zurich Municipal and that was in respect of the fire damage sustained by Willesden High School in 2000. The amount of the recovery was £383k which is the total of the loss in excess of the retained loss figure of £250,000 in force at the time. Brent has thus been paying significant premiums to Zurich since 1994 and only recovered monies on one claim.

3.1.9 In principle, these thresholds would remain, and the Mutual would only carry risk above these levels. The exact levels would be subject to the discussion on commercial terms between the Mutual members. In addition, the Mutual would reinsure the very highest level risks – for example, catastrophic risks where the claims involve very large sums of money – with a commercial insurer, after a procurement exercise benefiting from the extra purchasing power of a group of local authorities. Therefore the Mutual itself would only have to cover mid-range claims, above the deductible limits and below the level for reinsurance. These would be met from the premiums paid to the Mutual and the capital held by it, or, if that should prove insufficient, by contributions from the participating authorities who have placed insurance with the Mutual that year. The maximum amount levied on a participating authority in respect of any one financial year without a special resolution passed by the authorities at an annual or extraordinary general meeting is 50% of the premium paid by each authority in relation to that financial year. This right by the board of directors to raise additional premium income is considered to be very much a last resort. The intention is that the reinsurance protection afforded to the Mutual covers the risk of adverse years, therefore this right is not one expected to be exercised in practice.

3.1.10 The advantage for the authority in participating in a Mutual is the economic benefit both to the authority itself and to its area as a result of the reduction in premiums which frees up council money for other spending. There is an additional advantage for all the participants, because the Mutual can develop risk management standards for its members to encourage better risk management practice, and reduce unmanaged risk. The Mutual could offer financial inducements to participating authorities that met these standards.

3.2 <u>The form of Mutual</u>

3.2.1 CTC reported that a mutual was economically viable. There are two basic models. A “discretionary” mutual is under no obligation to meet its members’ claims. Although this has tax advantages, and the mutual need not register with the Financial Services Authority (FSA), it offers local authorities insufficient security. A “guaranteed indemnity” mutual is obliged to meet valid claims. CTC recommended establishing a guaranteed indemnity mutual, domiciled in the United Kingdom and authorised by the FSA to act as an insurance company.

3.2.2 A mutual called “London Authorities Mutual Limited” (LAML) has been set up as a shell company, but is not yet operating. It can only operate when a sufficient number of London authorities agree to take part and when FSA registration has been completed. This report forms a critical part of the establishment process, without sufficient numbers in support of the Mutual it will simply not happen.

3.2.3 LAML is a company limited by guarantee. London authorities that wish to take part in the Mutual will become full members. They will have equal voting rights. They will agree to take part in the Mutual arrangements. They will appoint the board of directors to run the company. Each year, the company will issue policies of insurance to the full members in accordance with their circumstances at the time.

3.2.4 It is recommended that the directors should be selected from the Finance Directors of the full member authorities. LAML will indemnify the directors against any personal liability and will place insurance to back up the indemnity. Directors will determine the strategy of the company and monitor performance.

3.2.5 Day-to-day management of LAML, including administration, issuing annual policies, arranging reinsurance and investing LAML's funds will be handled by an experienced firm of "pool providers". LAML will procure these services by competitive tender.

3.2.6 A minority of directors (initially two) will be independent directors. This is a requirement of the FSA and of the Code of Governance for mutuals of this kind. The non-executive directors will have experience of the insurance industry. They will be paid for performing that role, but the local authority nominee directors will only receive their reasonable incidental expenses.

3.2.7 Members may be aware that Municipal Mutual (MMI) was for many years a major insurer for local authorities. MMI operated as a mutual. MMI ceased trading in September 1992 and is currently in solvent run-off. Members need to be satisfied that the model of the proposed mutual is different from that of MMI. The key differences are a) the MMI Group in its latter period of operation was not focused purely on the public sector whereas LAML would be constitutionally restricted to providing insurances to local government in London b) the influence exercised by local authorities over MMI was diluted in the latter years c) the regulatory and compliance regime under which the LAML will operate is more onerous than any under which MMI operated d) the structure of the insurances MMI offered did not incentivise the practice of risk management whereas the insurance programmes provided by the LAML require and reward good risk management practice and e) MMI's investment portfolio was heavily biased towards commercial property. LAML will adopt an investment strategy which favours short-term investments and maximises liquidity.

3.3 <u>Capitalisation</u>

3.3.1 FSA registration requires the Mutual to be able to access a capital fund sufficient to cover its prospective liabilities. The size of the fund will depend on the number of members, but it is anticipated that the initial fund will be in the region of £5 million.

3.3.2 Authorities which become full members will be required to provide a financial guarantee of no more than £1m. It is believed from advice taken that the amount of the guarantee will not need to be provided for in the accounts of the authority. It would be regarded as a contingent liability with a note to the Council's annual accounts explaining this. LAML will decide the basis on which authorities joining the Mutual at a later time contribute their share to the on-going capitalisation requirements of the Mutual and such basis will recognise the benefits to the Mutual of the initial contributions.

3.4 Procurement

3.4.1 The London Borough of Croydon has engaged Weightmans solicitors to advise on setting up LAML. Specialist procurement counsel has advised that because LAML is controlled exclusively by the participating local authorities, and carries out the essential part of its activities for them, there is no need to comply with the European procurement rules or the Public Contracts Regulations 2006 to set up and participate in LAML on the basis indicated in this report. This point is expanded upon in the legal implications section. Brent has incurred no direct expenditure in obtaining this advice as the project has obtained financial support from the London Centre of Excellence.

3.4.2 LAML itself will be obliged to comply with the 2006 Regulations when it places contracts for services covered by the rules e.g. administration services, re-insurance, etc.

3.5 The Brent Position

3.5.1 Each London Borough has developed its own insurance arrangements over a long period. Officers feel that the Council has not received value for money from Zurich, given our claims history, in comparison with many other Boroughs. It is also felt that service standards provided by Zurich could be improved upon. However, the limited competition in the market has meant that our options were limited. The proposed Mutual offers an opportunity to challenge this market situation. This project though is not without risk. London Boroughs, while generally supportive of the principle, have been somewhat unwilling to commit to the Mutual. This understandable doubt has been based partly on not having a clear idea of the structure of the Mutual and the number of likely participants. Most authorities can afford to adopt this *"wait and see"* position because their current insurance agreements do not expire on 1st April 2007, unlike Brent. The Mutual project is now in a critical stage. In order to go ahead on 1st April 2007 authorities are being asked whether they support the proposal and if so when they will join. A critical mass of at least 6 boroughs is required if it is to go ahead. Brent is part of this first wave and hence will need to make a decision quickly. If this critical mass is not reached an alternative option being considered would be to set up the Mutual as a company but not take on authorities cover until 1st April 2008.

Due to the uncertainties set out above the Council is therefore seeking to pursue two main parallel strategies:

(a) The first is to explore further the possibility of becoming part of the Mutual from 1st April 2007. This is subject to further legal advice and satisfactory clarification of any commercial issues that currently remain uncertain. It is the intention of officers to bring a further report to the Executive, probably in November, to seek agreement to commit to the scheme..

(b) At the same time the Council is preparing to tender its insurance cover in the market for a period of 1, 3 and 5 years. Such a tender process would allow Brent to obtain its insurance requirements if it decided not to proceed with the mutual option at all, or to award just a one-year interim contract should the Mutual not be ready to award insurance contracts from 1st April 2008. A note to potential tenderers will be included in the advert so as to be as open and transparent as possible.

4.0 Financial Implications

4.1 The Council will pay £1,211k in premiums in 2006/07. This is split as follows:

	£'000
Property (including terrorism)	641
Liabilities	251
Motor Vehicles and Other	319
	1,211

However, the Mutual will not cover leasehold properties, because of the difficulties involved relating to consultation with residents, and Brent Housing Partnership are separately obtaining cover from 1st April 2007. This element of the premium amounts to £279k. Therefore, the adjusted premium payment for 2007/08 will be £932k. A minimum saving of 15% will accrue from this in 2007/08 amounting to £140k if Brent joins a Mutual. This can be utilised within the 2007/08 budget to fund priority growth or reduce overall expenditure. It is hoped and expected from the financial projections that as underwriting profits are retained for the benefit of Members through lower premiums the savings will increase.

4.2 The council would also seek to benefit from improving its risk management, with support from the Mutual. This will not only lessen the financial risk to the Mutual, but also help to reduce payments out of the Council's self insurance Fund.

4.3 Attached as Appendix 1 is a summary of the financial modelling undertaken by CTC to test the financial viability of the Mutual. 4 main scenarios and 3 models are tested.

4.4

- Model One – projects a Mutual commencing operations on 1st April 2007 with 6 members in 2007 and a further 2 members in 2008. No further members are acquired and no members are lost during the first 5 years of operation. The Mutual retains the first £1m of any one occurrence. The balance being met by the re-insurance acquired. Taking into account a 15% 'up front' premium saving and a retained surplus for members, the projected saving for the authority in the first 5 years of operation is **22.76%** over current 2006 premium rates.
- Model Two – projects a Mutual commencing operations on 1st April 2008 and retaining £1m of any one occurrence. The membership consists of the 8 members envisaged in Model One plus up to 50% of the London Boroughs whose Long Term Agreements expire in 2008. No further members are acquired and no members are lost. Taking into account a 15% 'up front' premium saving and a retained surplus for members, the projected saving for the authority in the first 5 years of operation is **23.19%** over current 2006 premium rates.
- Model Three – projects a Mutual commencing operations on 1st April 2008 and retaining £2.5m of any one occurrence in respect of Liabilities and £5m of any one occurrence in respect of Property. The membership consists of the 8 members envisaged in Model One plus up to 50% of the London Boroughs whose Long Term Agreements expire in 2008. No further members are acquired and no members are lost. Taking into account a 15% 'up front' premium saving and a retained surplus for members, the projected saving for the authority in the first 5 years of operation is **26.45%** over current 2006 premium rates.

4.5 These projections are based on previous claims history. The sensitivity analysis also looks at other scenarios. Council officers sought independent advice on the assumptions and results within the models. PwC, our external auditors, have a specialist insurance section within their firm and provided this review. The key issue highlighted is assessing what the potential downsides could be for Brent and whether or not this represents an acceptable level of risk. This financial downside would be generated in circumstances where claims from members of the Mutual, not met by the members excess provision or by the level of reinsurance bought by the Mutual to cover significant claims, need to be funded directly from the mutual's own resources. Referring to the scenarios in Appendix 1 this could occur after a number of *"poor"* years. Reinsurance will be purchased to cover a single catastrophic year. The process in a year in which additional contributions would be required is set out in paragraph 3.1.9.

4.6 The Director of Finance and Corporate Resources believes further modelling based on the first wave of participants of the mutual rather than the 26 Boroughs currently used should be undertaken before a final decision is taken. This issue will be addressed in the November report to the Executive.

4.7 This would allow a more accurate and detailed assessment to be made and for Members to more fully assess the financial risk. Present indications are that 9 London Boroughs are taking reports to their Executives in October or

early November with recommendations to join the Mutual. The GLA and the City of London will not be part of this arrangement. A number of others, because they are in the middle of extended contracts, will review the position closer to the end of their current arrangements. An update of the position will be given at the meeting.

4.8 The Council also incurs additional external administrative costs in running the insurance service. These are brokers' fee of £5k, claims handling fee of £55k and legal fees of £80k. These are initially anticipated to be at around the same level in 2007/08 although arrangements will need to be amended to reflect the new circumstances.

4.9 The cost of the tendering exercise will be met from existing resources. Much of the work planned to be undertaken would be required if the Council were to join the Mutual.

4.10 **Risk analysis**

4.10.1 **Risk: The risk of the cost of capitalisation**

Advice from the Financial Services Authority is that initial capitalisation can be provided in the form of a guarantee by each authority which would be treated as a contingent liability rather than having to 'tie up' additional capital in the vehicle.

4.10.2 **Risk: How will the Mutual guard itself against the risk of recapitalising?**

The Board of Directors of the Mutual have the powers to require members to make supplementary calls in the event that the Mutual has or is considered to be likely to need additional resources.

It will be necessary for the Board of Directors to ensure that the Mutual, will underwrite prudently and will structure its reinsurance protection in such a way that will mean that the Mutual's net assets are unlikely to be insufficient to meet its retained liabilities.

The Mutual will be exposed to the risk of failure of its reinsurance programme but will be placing its reinsurance with reinsurance markets whose Standard & Poor's financial rating is A or above.

4.10.3 **Risk: A potential threat to the viability of the Mutual could be the long tail nature of its liabilities.**

The Mutual will write Employers' Liability and Public/Products Liability covers on a claims occurrence basis. Consequently, it is exposed to the long tail nature of these classes and any deterioration in experience over time.

In establishing its claim incurred but not reported allocation the Mutual will use consulting actuaries to ensure that it is adequately reserved. The Mutual will adopt a conservative approach to claims reserving and IBNR allocation.

The Mutual may explore the possibility of buying loss portfolio protection once a particular underwriting year is considered to be mature in order to release reserves and to protect itself against adverse deterioration.

4.10.4 **Risk: How will the Mutual guard against adverse selection?**

Information provided to Brent states that each authority applying for membership of the Mutual will be assessed and underwritten on its own merits. There will be no blanket underwriting approach. Assessments will be based inter alia on the exposures a potential member brings to the Mutual, its historic loss record and its approach to managing its risks. An authority exhibiting poor traits in one or more of these areas will be treated no differently from a pricing standpoint than it would be by the conventional insurance market.

4.10.5 **Risk: How can a member exit from the Mutual?**

Although the expectation is that members will see considerable benefits from membership of the Mutual, it is inevitable (and healthy) that from time to time members will want to exit from the Mutual. Members will be free to do this upon the expiry of any long term agreement arrangement they have entered into with the Mutual or in the event that they are unable to agree upon renewal terms during the course of a long term agreement.

Under the rules of the Mutual, a member terminating their membership of the Mutual is not absolved of their financial obligations to the Mutual in respect of the years in which they bought cover from the Mutual. That means that in the event that the Board of Directors deem it necessary to make a supplementary call in respect of any one or all of the financial years in which an authority was a member of the Mutual, that member, even though they are no longer members of the Mutual, will be required to contribute their share of the supplementary call. Former members of the Mutual forego their entitlement to any distribution of surplus.

Under the rules of the Mutual there is a provision whereby a member who has left the Mutual may enter into a commutation agreement with the Mutual whereby their liabilities in respect of the years in which they were members are assessed. Following the commutation exercise the member will either be absolved from their liabilities at no additional cost or be required to pay additional monies to the Mutual. In either event, a member whose membership has been commuted will forego any rights to a share of the distribution of any surplus.

4.10.6 Risk: How will the Mutual determine its investment strategy?

The investment strategy to be adopted by the Mutual will be determined by the Board of Directors and is likely to follow public sector guidelines. In the early years of the Mutual it is likely that the Mutual will adopt a very conservative investment strategy, concentrating on short-term investments to maximise liquidity.

4.10.7 Risk: Heavier expense base than a commercial insurer?

The proposal is that the Mutual at the outset outsources its day-to-day management to professional Mutual managers, thereby allowing the Mutual to derive the benefit of economies of scale which would not be available to it if it had to recruit full-time employees.

The Mutual should operate with lower acquisition costs because it will not be paying commissions and does not have the same level of profit demands that a joint stock insurance company has.

A Mutual is more tax efficient than a joint stock insurer because its corporation tax liability is only in respect of its investment income gains rather than in respect of its operating profits.

Over time the expense ratio may increase as a percentage of premium written but this would be a sign of success because it means that the Mutual is delivering reduced premiums to its membership on the back of successful underwriting and risk management strategies.

4.10.8 Risk: Bad management

Joint stock insurance companies are just as susceptible to bad management as a Mutual insurance company. The Mutual's initial strategy is to appoint professional managers to carry out the day-to-day activities of the Mutual. The managers will be accountable to the Mutual's Board of Directors, who will comprise of insurance professionals as well as representatives of the membership, and their appointment will be reviewed periodically and will subject to competitive bid.

4.10.9 Risk: Poor Governance: How does the Mutual ensure good governance?

The proposed constitutional documentation of the Mutual prescribes the governance arrangements of the Mutual. The Board of Directors in conjunction with the risk management sub committee would be responsible for ensuring that the Mutual adheres to its constitutional responsibilities and that it practises good governance. The Board of Directors are accountable to the membership annually at annual general meetings and members have the right to call extraordinary general meetings if it is deemed to be necessary.

4.10.10 **Risk: How will the Mutual ensure that it gains critical mass and maintains momentum?**

Financial models have been built to determine minimum critical mass and strategies have been determined to allow the Mutual to grow its net retention in line with business acquisitions.

The Mutual through its Board of Directors and its managers will be pro-active in marketing to prospective members and in demonstrating the financial viability of the Mutual and the financial and other benefits which will accrue from membership.

4.10.11 **Risk: How will the Mutual deal with competition in the market?**

Extensive legal opinion has been sought by those leading on the project which has indicated that authorities can opt to place insurance directly through the mutual of which they are a member. These legal opinions, however, may be challenged either within or outside of the authority. The Borough Solicitor is currently assessing these opinions as they are not conclusive in some respects and is seeking further independent counsel's advice. This will be reported to members in due course and before they are asked to commit to the project. The control measure in place is that the Mutual will have a set of accounts open to all and therefore will be seeking to display a complete level of transparency that will demonstrate best value for the participants. A full EU procurement exercise will be undertaken for reinsurance.

4.10.12 **Risk: How does the Mutual sit with the (potentially) short-term perspective of government?**

Clearly the establishment of and participation in a mutual structure is a medium to long-term strategic initiative. The majority of the financial benefits will accrue to members in the longer term – build up of surpluses, financial benefits accruing from effective risk management practices – although there will be short-term advantages from competitive premiums and reduced frictional costs arising from the procurement processes and the structuring of cover.

It is not envisaged however, that the Mutual will force its members into long term agreements in the way that some commercial insurers do and, therefore authorities will stay in the arrangement on an annual basis as they see fit.

5.0 Alternative option: a tender process in the open market

5.1 If the proposal to insure through the Mutual does not go ahead for whatever reason, then it will be necessary to award a contract for insurance services from 1st April 2007, as this is when Brent's current policies expire. This award will need to be preceded by an EU-compliant tender process for services. A short-term contract following a tender process is also an option should Brent decide to commit to the project but if the Mutual is not ready to issue cover for 1st April 2007.

5.2 It is necessary to take some steps towards a tender process now to ensure that it can be conducted according to all the procedural requirements and awarded before 1st April 2007. Accordingly a broker (Marsh) has been appointed to work with the Council on this potential tender process for the Council's insurance needs.

5.3 The Council's Contract Standing Orders state that contracts for services exceeding £500,000 shall be referred to the Executive for approval to invite tenders and for other matters set out in this paragraph. Assuming that approval is granted, then advertisements are to be placed to seek companies to tender. The tender will be advertised through the Official Journal of the European Union under the Open Procedure in line with UK Law and EC Directives. It is proposed to allow for alternative options for contract length (known as Long Term Arrangements in the industry) of 1, 3 or 5 years, each with provision for a one-year extension.

5.4 Those organisations that respond to the advert will be sent the tender pack. Part of the pack will address issues of Business Probity, Economic and Financial Standing, Experience, Health & Safety and Equality. The pack will also include a detailed specification. The tenders will be evaluated to obtain the most economically advantageous tender (including the taking up of references) in accordance with the following proposed evaluation criteria:

- Financial competitiveness and affordability
- Ability to meet the requirements of the service specification
- Quality control and assurance
- Technical competencies associated service provision
- Customer Care
- Ability to ensure smooth and seamless implementation

Timetable

Date	Action
27 September 2006	Start up meeting with Marsh
28 September 2006	Draft Specification and Documentation
27 October 2006	Place Advert
30 October 2006	Tender
21 December 2006	Closing Date
22 December 2006	Evaluate Responses
12 January 2007	Interviews
12 February 2007	Executive Report to Approve Contract
23 February 2007	End of Standstill Period and award contract
1 April 2006	Commence Contract

6.0 Legal Implications

6.1 Counsel instructed by those leading on the project and who specialises in local government law has advised that it is within the power of local authorities to participate in the Mutual. The primary source of legal power identified is section 2 of the Local Government Act 2000. Under section 2, a local authority has power to do anything which it considers is likely to achieve the promotion or improvement of the economic, social or environmental well-being of its area. The power may be exercised in relation to, or for the benefit of, the whole or part of the local authority's area, or all or any persons resident or present in that area. A local authority may act outside its own boundaries provided the intention is to benefit its own area. The two limitations on the section 2 power set out in section 3 do not apply as there is no legal prohibition, restriction or limitation preventing the establishment of the Mutual, and the authorities are not establishing the Mutual to raise money (whether by precepts, borrowing or otherwise). Counsel has advised that "person" includes the authority itself and that promotion of the economic well being of the authority (through a reduction in the cost of insurance premiums which frees up council money to be spent for other purposes) is sufficient for the section 2 power to be available. This is a very broad interpretation of the section and is not based on any decided cases. The Borough Solicitor is seeking a further opinion on whether section 2 can be relied upon in these circumstances. It is anticipated that this further advice will be obtained on a joint basis with some other of the London Boroughs.

6.2 In exercising the section 2 power, the authority must have regard to guidance issued by the Secretary of State and to its community strategy, which in Brent is known as the community plan.

6.3 The guidance issued by the Secretary of State does not specifically address the question of whether local authorities may combine to form a Mutual, but it is strongly supportive of the concept of Mutual cooperation and assistance between local authorities.

6.4 Brent's Community Plan does not contain any objects that are relevant to the question of the Council seeking to join the proposed Mutual, but nor are there any objectives that contradict this proposal.

Comment: Have you considered the community plan?

6.5 This authority therefore needs to satisfy itself that the anticipated financial and risk management benefits from participation in the Mutual are likely to achieve the promotion or improvement of the well-being of the area, the economic well-being of the authority, and, from the application of savings to other services or to a reduction in local taxation, the economic, social and/or environmental well-being of the area or of persons resident or present in it.

6.6 The proposed company vehicle for the Mutual is a company limited by guarantee. Each participating local authority will be a member guaranteeing the liabilities of the company. Each member will put forward a Member Representative, and the Directors will be drawn from this pool (plus two independent directors). As a Mutual there is joint liability for deficits as well as the ability to distribute surpluses to the members. This is the most appropriate vehicle for a project of this type.

6.7 Under the Public Contracts Regulations 2006, insurance services are required to be subject to the full tendering requirements set out in the Regulations, where the total value over the term of the contract exceeds £144,371. Consequently the tender process proposed in section 5 (to be followed to allow for the possibility of Brent not proceeding with the Mutual or it not being in a position to offer insurance from 1st April 2007) is an EU-compliant process. Due to the application of the Regulations, it is not possible to extend the existing five-year Long Term Arrangement, because this was not set out in the original EU contract notice.

6.8 More problematic is the application of the EU rules in the event of proceeding with the Mutual, as indicated above. Under the proposals, Brent would be awarding a contract for insurance services without having first tendered these. Counsel has advised that participating authorities would be able to rely upon what has become known as the *Teckal* exemption. This exempts the application of the Regulations if a contract is awarded to an "in-house" company. In the same way that there is no award of a contract subject to the Regulations where one department within an authority provides a service to another, in the *Teckal* case the European Court of Justice held that this could be extended to a situation where an authority had control over a company similar to that it would exercise over one of its own departments. A further requirement is that the company carries out the essential part of its activities for the authority.

6.9 While the second of these requirements is fulfilled by the proposals for the Mutual, the first element about control is not clearly fulfilled. Here there will be a number of London authorities participating in the Mutual, and having membership rights, such that is it possible to say that Brent exercises control over the company similar to that it would exercise over its own department? There has been a very recent case in the European court, *Cabotermo*, where the court stated in passing that it was possible to have more than one authority controlling the "in-house" company, however this has not been tested.

6.10 The Borough Solicitor is also seeking advice on this issue, and will query whether those member authorities that do not have a Director representative (as opposed to a member representative which all authorities will have) can be said to have sufficient control to rely on the *Teckal* exemption.

6.11 Advisers for the project have indicated that if an individual member authority receives a challenge on the basis of *vires* (legal powers) or the ability to rely on the *Teckal* exemption, and this occurs after policies had been issued, such that the company is in funds, then it would be open to the Directors to consider funding the individual member's defence. This issue will be referred to counsel for advice.

6.12 In relation to the Council's Contract Standing Orders, this report raises issues in relation to both the proposal to place insurance with the Mutual and the parallel option of tendering in the market. Placing insurance contracts with the Mutual requires the Executive to agree an exception to Contract Standing Orders but this point will be addressed in the subsequent report.

6.14 In relation to the proposal to tender in the market, Contract Standing Orders requires paragraph 88 / 89 requires approval of certain pre-tender considerations and the proposed evaluation criteria as set out in section 5.

6.15 As with all its decisions, the authority needs to ensure that it has taken all relevant factors into account (including its duty to local tax payers to act responsibly with its funds), ignored irrelevant considerations, and come to a rational conclusion.

6.16 Weightmans, Solicitors, have also taken advice from a third Counsel a European and competition law specialist. He confirmed there are no obstacles to the proposals in terms of competition law or state aid.

6.17 As LAML will be controlled by its local authority members, a number of straightforward statutory probity requirements apply. These include an obligation to provide members of a participating authority with such information about the company as they may reasonably require for the participation of their duties, so that the company may be subject to scrutiny, and an obligation to keep non-exempt minutes of its general meetings available for public access for four years.

Comment: Something more explicit about regulated companies?

6.18 If the Mutual proposal is proceeded with then Brent will need to execute its guarantee in support of the overall submission to the Financial Services Authority in December.

7.0 Next steps for the Mutual

7.1 Each London authority is being asked to agree to become a full member. A meeting of London Treasurers is taking place on 22nd September to establish the position being recommended to each authorities Members. This will help to inform the Executive at its meeting.

7.2 Authorities agreeing to become full members will be asked so to resolve and to agree to capitalise the Mutual as required.

7.3 FSA registration as an insurer is being sought.

7.4 The initial directors will formally establish the company as a Mutual and appoint independent directors.

7.5 The company will formally procure the appointment of pool providers and reinsurance. If necessary, CTC's engagement will be extended for a transitional period pending the appointment. CTC will not, however, be involved in the procurement of pool providers, which will be undertaken on behalf of LAML by a lead authority as agreed by the directors of LAML.

7.6 These formalities can be completed in time for LAML to issue policies from 1 April 2007.

7.7 In the event that LAML cannot issue policies until 1 April 2008 because of some unforeseen delay, authorities with long term insurance agreements expiring before that date could either arrange an extension, procure short-term cover or ask LAML to arrange to purchase cover, thereby benefiting from a consortium purchasing arrangement. Brent will consider all these options.

8.0 Diversity Implications

8.1 The proposals in this report have been subject to screening and officers believe that there are no diversity implications arising from it.

9.0 Staffing/Accommodation Implications (if appropriate)

9.1 All options in the report are likely to lead to a change in working practice for those involved in insurance work.

10.0 Background Papers

1. Financial Plan for the Mutual

2. 'How does the Mutual work' document

3. LAML Accounting Issues

4. Memorandum and Articles of Association of the Mutual and Rules of the Mutual

5. Advice from Roger Henderson QC on legal powers.

6. Advice from Rhodri Williams QC on procurement

7. Advice from Julian Maitland-Walker solicitors on competition law and state aid

8. Advice from Weightmans solicitors on directors' responsibilities, probity controls and information management.

9. General fine on Insurance Mutual

11.0 Contact Officers

11.1 Duncan McLeod, Director of Finance and Corporate Resources , Room 114b, Brent Town Hall, Forty Lane, Wembley, Middlesex HA9 9HD. Tel. 020 8937 1424.

DUNCAN McLEOD
Director of Finance and Corporate Resources

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THE LONDON AUTHORITIES' MUTUAL
Financial Models

Introduction

Financial models have been developed to test the financial viability and robustness of the London Authorities' Mutual Limited (LAM). Using actual historic loss data provided by 29 London authorities four loss scenarios have been developed as follows:

- Expected Loss scenario – this is the expected loss scenario based on the actual loss history of the participating authorities – 5 years for Property and 10 years for Liability.

- Good Loss scenario – this is a loss scenario which is better than the historic loss experience and could be achieved as risk management standards and practices are aligned and continue to improve.

- Poor Loss scenario – this is a loss scenario which is worse than has been experienced over the last few years by the participating authorities. This scenario may represent an unfortunate run of School fires or a higher than anticipated occurrence of large Liability claims.

- Catastrophic Loss scenario – this is a loss scenario where a serious event or a series of serious events hits the participating authorities. In this scenario there could be a serious Terrorist incident or incidents, a Thames flood and/or a serious wind/rain storm.

Each loss scenario has been allocated to each of the major classes – Property, Terrorism and Liability – at random for each of the five financial years being modelled.

The allocation has been weighted such that there is a 60% chance of an Expected loss scenario being allocated, a 20% chance of a Good loss scenario, a 19.5% chance of a Poor loss scenario and a 0.5% of a Catastrophic loss scenario.

The financial model has then been run 5,000 times and at the end of each iteration the following financial outputs are produced:

- Profit & Loss accounts
- Balance Sheet
- Cash-flow statement
- Solvency Margin Testing[1]

[1] On the basis of the anticipated premiums written and the loss activity the model automatically checks the net assets of the mutual against the solvency margin required by the Financial Services Authority (FSA) and expresses the net assets as a percentage of the required solvency margin. If the percentage is less than 100, the model automatically recapitalises the mutual with the difference between the net assets and the required solvency margin.

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Premium rates are set at 2006 levels less 15% (the projected 15% upfront saving on premium rates). Exposure units are adjusted annually by the assumed inflation factors (see Assumptions below).

The model also tests the reinsurers' loss ratio. If the reinsurers' loss ratio is greater than 60% (i.e. loss recovered or recoverable from reinsurers are in excess of 60% of the premium charged by reinsurers), the reinsurance premium for the subsequent years is increased by 50%. Where reinsurance premiums are adjusted upwards, this as a knock-on effect on the gross premium paid to the mutual by the participating authorities.

Models

Three membership scenarios were modelled, as follows:

- Model One – a mutual commencing operations on 1st April 2007 with 6 members in 2007 and a further 2 members in 2008. No further members are acquired and no members are lost during the first 5 years of operation. The mutual retains the first £1m any one occurrence.

- Model Two – a mutual commencing operations on 1st April 2008 and retaining £1m any one occurrence. The membership consists of the 8 members envisaged in Model One plus up to 50% of the London Boroughs whose Long Term Agreements expire in 2008. No further members are acquired and no members are lost.

- Model Three – a mutual commencing operations on 1st April 2008 and retaining £2.5 any one occurrence in respect of Liabilities and £5m any one occurrence in respect of Property. The membership consists of the 8 members envisaged in Model One plus up to 50% of the London Boroughs whose Long Term Agreements expire in 2008. No further members are acquired and no members are lost.

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Assumptions

The following assumptions have been used in the modelling exercise:

Underwriting & Premium	Claims	Expenses & Investment
Premium rates set at 85% of the expiring 2006 rates	Four loss scenarios Good – set at 20% confidence level (1 year in 5 low) Expected – set at expected level Poor – set at 80% confidence level (1 year in 5 high) Catastrophic – set at 99.5% confidence level (1 year in 200 high)	Reinsurance Costs Assuming £1m retention Liability – 40% of Gross written Premium Property – 60% of Gross written Premium Terrorism –90% of Gross written Premium Assuming £2.5m/£5m retention Liability – 30% of Gross written Premium Property – 40% of Gross written Premium Terrorism – 90% of Gross written Premium
Wages & salaries estimates increase by 3% per annum compound	Incurred Loss distribution – as per original feasibility study	Management Fees – 5% of Gross Written Premium
Total sums insured increase by 5% per annum compound	Paid Loss distribution – as per original feasibility study	Set Up Costs - £250,000 spread over 3 years
Motor premiums and losses have not been modelled	Incurred But Not Reported Reserve (IBNR) – the reserve established is the difference between the ultimate loss ratio for the underwriting year and the incurred loss amount	Statutory Company expenses - £50,000 in year one, adjusted by expense inflation thereafter
Aggregate Stop Loss protection – the model assumes that the mutual has purchased aggregate stop loss protection for its (the mutual's) aggregate exposure. The cover would stop the aggregate losses at the 80% confidence level.		Expense Inflation – 5% per annum Insurance Premium Tax – 5% per annum Regulatory Capital - £5,000,000 Investment Income return – 5% per annum

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Results

Model One

Commencing operations on 1st April 2007 with 6 members in 2007 and a further 2 members in 2008. No further members are acquired and no members are lost The mutual retains the first £1m any one occurrence.

Expected (£m)					
	Financial Year 1	Financial Year 2	Financial Year 3	Financial Year 4	Financial Year 5
Gross Written Premium (ex IPT)	3.6087	5.8907	6.1532	6.4279	6.7153
Net Earned Premium	0.9095	2.3451	2.3259	2.4225	2.5234
Total Net Loss	0.4764	1.2811	1.0950	1.0992	1.1401
Total Expenses	0.4694	0.7126	0.6916	0.6720	0.7039
Profit/Loss after Investment Income	0.1092	0.5401	0.7535	0.8986	0.9568
Profit/Loss after Tax	0.0815	0.5043	0.7128	0.8488	0.9057
Loss Ratio	52.37%	54.63%	47.08%	45.37%	45.18%
Expense Ratio	51.61%	30.39%	29.74%	27.74%	27.90%
Combined Ratio	103.98%	85.02%	76.81%	73.12%	73.08%
Balance Sheet (£m)					
Total Assets	6.0753	7.3119	8.7214	9.9979	11.1846
Liabilities	0.9595	1.8323	2.5430	3.1286	3.5774
Equities	5.0815	5.4995	6.1627	6.8769	7.6289
Cash Flow (£m)					
Balance Brought Forward	0.0000	6.0277	7.1899	8.5442	9.7059
Cash inflow	9.0550	6.6233	7.0071	7.3660	7.7264
Cash Outflow	3.0273	5.3117	5.7622	6.1585	6.5775
Balance Carried Forward	6.0277	7.1899	8.5442	9.7059	10.8295
Solvency					
Net Assets	5.0815	5.4995	6.1627	6.8769	7.6289
Times Covered	336.83%	364.54%	407.19%	454.06%	504.02%

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Model Two

Commencing operations on 1st April 2008 and retaining £1m any one occurrence. The membership consists of the 8 members envisaged in Model One plus up to 50% of the London Boroughs whose Long Term Agreements expire in 2008. No further members are acquired and no members are lost.

Expected (£m)					
	Financial Year 1	Financial Year 2	Financial Year 3	Financial Year 4	Financial Year 5
Gross Written Premium (ex IPT)	7.8625	8.2251	8.7334	9.6320	10.0848
Net Earned Premium	2.8638	3.1129	3.2477	3.6360	3.8015
Total Net Loss	1.5320	1.6452	1.6493	1.8103	1.8884
Total Expenses	0.8727	0.9130	0.9016	0.9339	0.9801
Profit/Loss after Investment Income	0.6196	0.7730	0.9895	1.2268	1.3149
Profit/Loss after Tax	0.5864	0.7282	0.9424	1.1690	1.2444
Loss Ratio	53.49%	52.85%	50.78%	49.79%	49.67%
Expense Ratio	30.47%	29.33%	27.76%	25.68%	25.78%
Combined Ratio	83.97%	82.18%	78.55%	75.47%	75.46%
Balance Sheet (£m)					
Total Assets	6.9603	8.7435	10.5049	12.4220	14.2178
Liabilities	1.3850	2.4918	3.3902	4.2023	4.8663
Equities	5.5864	6.2520	7.1009	8.1665	9.2937
Cash Flow (£m)					
Balance Brought Forward	0.0000	6.8306	8.5421	10.1644	11.9887
Cash Inflow	13.7637	9.3444	9.8518	10.9947	11.5594
Cash Outflow	6.8239	7.5114	8.1040	9.2111	9.8341
Balance Carried Forward	6.8306	8.5421	10.1644	11.9887	13.6605
Solvency					
Net Assets	5.5864	6.2520	7.1009	8.1665	9.2937
Times Covered	369.13%	411.05%	465.99%	527.80%	596.37%

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Model Three

Commencing operations on 1st April 2008 and retaining £2.5 any one occurrence in respect of Liabilities and £5m any one occurrence in respect of Property. The membership consists of the 8 members envisaged in Model One plus up to 50% of the London Boroughs whose Long Term Agreements expire in 2008. No further members are acquired and no members are lost.

Expected Performance (£m)	Financial Year 1	Financial Year 2	Financial Year 3	Financial Year 4	Financial Year 5
Gross Written Premium (ex IPT)	8.0032	8.3608	8.7350	9.7069	10.1486
Net Earned Premium	3.8178	4.1352	4.3582	4.8637	5.0888
Total Net Loss	2.1967	2.3814	2.3993	2.6974	2.8070
Total Expenses	0.8820	0.9211	0.9102	0.9397	0.9848
Profit/Loss after Investment Income	0.9475	1.0709	1.2535	1.5633	1.6514
Profit/Loss after Tax	0.9111	1.0305	1.1970	1.4971	1.5765
Loss Ratio	57.54%	57.59%	55.05%	55.46%	55.16%
Expense Ratio	23.10%	22.28%	20.89%	19.32%	19.35%
Combined Ratio	80.64%	79.86%	75.94%	74.78%	74.51%
Balance Sheet (£m)					
Total Assets	7.3953	9.5795	11.7326	14.0876	16.3649
Liabilities	1.5476	2.7008	3.6315	4.5032	5.1968
Equities	5.9111	6.8101	8.0078	9.5046	11.0568
Cash Flow (£m)					
Balance Brought Forward	0.0000	7.3702	9.5255	11.5455	13.8057
Cash Inflow	13.6194	9.0719	9.5515	10.7279	11.3007
Cash Outflow	6.0907	6.7970	7.4270	8.4708	9.1051
Balance Carried Forward	7.3702	9.5255	11.5455	13.8057	15.9285
Solvency					
Net Assets	5.9111	6.8101	8.0078	9.5046	11.0568
Times Covered	384.54%	439.83%	512.45%	579.13%	658.29%

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Sensitivity Testing

The results above represented the expected position for each of the models given the assumptions and the allocation of loss scenarios. Statistically, these are the average results. The tables below show for each model the range of values for net assets at the end of each financial year.

Model One – Mutual starts on 1st April 2007 and retains £1m any one occurrence

Net Assets	Worst	95% chance better than	90% chance better than	80% chance better than	Expecte d – 50% chance better ♣than	20% chance better than	10% chance better than	5% chance better than	Best
Fin Year 1	4.314	4.817	4.817	4.926	5.082	5.190	5.221	5.300	8.745
Fin Year 2	4.216	4.894	5.060	5.224	5.500	5.853	6.019	6.196	13.120
Fin Year 3	4.438	5.214	5.411	5.676	6.163	6.598	6.850	6.986	15.649
Fin Year 4	4.748	5.758	5.973	6.287	6.877	7.436	7.763	8.022	19.240
Fin Year 5	5.026	6.307	6.610	6.953	7.629	8.299	8.673	9.052	23.059

Model Two – Mutual starts on 1st April 2008 and retains £1m any one occurrence

Net Assets	Worst	95% chance better than	90% chance better than	80% chance better than	Expecte d – 50% chance better ♣than	20% chance better than	10% chance better than	5% chance better than	Best
Fin Year 1	4.050	4.799	4.875	5.127	5.586	6.021	6.205	6.374	19.317
Fin Year 2	3.983	4.996	5.259	5.637	6.252	6.904	7.306	7.622	22.554
Fin Year 3	4.065	5.573	5.902	6.276	7.101	7.968	8.553	9.038	40.490
Fin Year 4	4.528	6.278	6.682	7.161	8.166	9.358	10.052	10.731	44.444
Fin Year 5	4.756	7.128	7.556	8.098	9.294	10.791	11.706	12.538	49.091

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Model Three – Mutual starts on 1st April 2008 and retains £2.5m any one occurrence in respect of Liabilities and £5m any one occurrence in respect of Property

Net Assets	Worst	95% chance better than	90% chance better than	80% chance better than	Expected – 50% chance better ♣than	20% chance better than	10% chance better than	5% chance better than	Best
Fin Year 1	2.428	5.023	5.076	5.300	5.911	6.360	6.658	6.963	8.386
Fin Year 2	2.540	5.401	5.717	6.082	6.810	7.671	8.237	8.709	11.232
Fin Year 3	3.208	6.271	6.613	7.094	8.008	9.177	9.868	10.476	14.688
Fin Year 4	3.693	7.251	7.741	8.258	9.505	11.004	11.866	12.657	18.593
Fin Year 5	4.530	8.392	8.843	9.563	11.057	12.908	13.956	14.773	25.781

Savings

For the purposes of the financial model it was assumed that LAM would be able to charge a premium that was 15% less than the premium paid by London authorities in 2006. In order to calculate the rate of savings the projected premium expenditure of members of LAM over the first five years and their share of any underwriting surplus or contribution to any underwriting deficit was compared with the premium that would have been paid, assuming no premium discount.

The expected results are as follows:

	Model One	Model Two	Model Three
Saving	22.76%	23.19%	26.45%