Watch your step

Insurers are changing the rules, and treasurers must not slip up, says John Birkenhead

THE RAPID INCREASE of public liability claims has raised the profile of council insurance funds with treasurers. As compensation claims rise at around 15% a year, insurers have restricted the amount of cover offered, causing increased cost to councils.

Claims paid out have increased rapidly in a number of key areas:

- Highways claims — for example, trips and slips on pavements — cost local authorities over £150m a year in compensation costs, three times the cost from 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 in the last decade.

Typically, an authority will pay out £1m-£5m a year in claims. Whereas in the past some of these amounts would have been recovered from the authority's insurers, following the recent reductions in available insurance cover, councils are now facing these costs virtually alone, placing increasing cash-flow strain on the authority and hence impacting the authority's treasury management function.

As claims typically take a number of years to be paid out in full, today's reduced insurance cover will not fully affect the cash-flows for a number of years. For budgetary control, simply assuming that the claims cash-flows "this year" will be "last year's plus inflation" is not enough.

There also are more subtle impacts which treasurers need to be aware of:

- Being uninsured for 'extreme' events such flood/storm claims
- Increased variability in the actual claims out-turn from one year to the next, even without 'extreme' claims, making cash-flow forecasting from year-to-year more difficult.

Claims which are not paid for by the authority's insurance cover are usually paid for out of the council's insurance fund. To forecast better the likely future claims cash-flow out of the fund, the liabilities of the fund and realistic fund contributions, more and more authorities are turning to independent actuaries.

Actuaries typically would like to obtain detailed data in order to identify and quantify claims trends for example, how the claims have been reported and settled, and the estimated cash-flows from the claims throughout their life. Unfortunately the quality of claims data held by councils is typically poor, usually consisting of a claims listing, merely showing a 'snapshot' of all claims at the valuation date with very little historic cash-flow data available.

In an extreme case of poor data, an actuarial opinion was actually refused for one London borough until better data was obtained. This new data revealed a multi-million pound insurance fund deficit, in an extremely challenging cash-flow environment. Indeed, the lat est 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 an authority in the south-east, the acquisition of new council areas, the floods in 2000-01, and the impact of claims management companies triggered a full actuarial review. The review recommended funding for a major flood claim at least once every five years, highlighted the poor quality of data from the incoming council areas, highlighted the cash-flow strain from the recent flood claims, set out what data should be collected in the future, and showed how this data could be used by the council to track trends in the data itself.

THE COST OF SCHOOL FIRES HAD DOUBLED OVER THE LAST FIVE YEARS

Another council, this time in Scotland, waited three years to have a fund review updated. The fund's deficit had doubled in that three-year period, due to rapidly deteriorating claims experience — increasing number and cost of claims, together with increased cash-flows. This deterioration could have been identified, and early warnings been sounded, just one year after the original review, had the council collected the data and had an appropriate analysis framework.

With such increased financial risks, councils should not wait for three years for each actuarial review of their insurance fund — a period which is commonly the case with authorities' pension valuations. As the cash out-go from claims becomes higher and more volatile, annual insurance fund reviews are becoming more important — and more common — in order to give early warnings which can be acted upon.

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. From a treasurer's perspective, there will be no incoming recovery payments from the council's insurers as there may have been in the past.

Local authority treasurers should therefore now be looking to annual insurance fund reviews to help them avoid unplanned cash-flow surprises.

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Claims for slips and trips cost councils £150m in compensation a year