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Risk financing in UK local authorities: is there a case for risk pooling?

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Abstract

Purpose – Since the early 1990s there has been a growth in local authorities of risk management. However, despite a range of different strategies, initiatives and practices the issue of financing the risks to which authorities are exposed has remained problematic. The traditional dependence on the commercial insurance market has proved to be a flawed strategy. This paper aims to analyse an alternative risk financing strategy which has been successful in local authorities in other countries, that of risk pooling.

Design/methodology/approach – The paper analyses the rationale behind risk pools, investigates the legislative environment that appears to make these acceptable to central government and evaluates the likely benefits to local authorities of their adoption.

Findings – The paper finds that the perceived main legislative barrier to risk pools may no longer exist. Given that, there is a strategic, financial and operational case to be made for at least exploring the possibility of risk pooling. The experience from the USA would suggest that pools can have an important role to play in risk financing, and evidence now exists that a number of UK local authorities are actively pursuing pool formation.

Practical implications – The development of risk pools is likely to result in a significant reduction in the use of conventional insurance by local authorities. The evidence would suggest that this will be beneficial, but this is subject to the proviso that actuarial, financial and managerial practice within pools is rigorous.

Originality/value – This is an under-researched area, with almost no extant UK-relevant academic, or indeed practitioner, literature. The paper adds to the understanding of public sector risk management and financing for both academic and practitioner audiences.

Keywords Local authorities, Risk management, Insurance, United Kingdom

Paper type General review

Introduction

Whether or not it has been expressly conceptualised and contextualised, risk and its management have long been issues for the public sector. Historically, however, the majority of literature analysing government-related, or public sector, risks has tended to adopt either a socio-political theorist perspective, although there is certainly no consensus amongst these theorists on the nature of risk and the most appropriate strategies for its management (see, for example, Fischhoff *et al.*, 1981; Douglas and Wildavsky, 1982; Douglas, 1985; Wildavsky, 1985; Plough and Krimsky, 1987; Giddens, 1990; Beck, 1992), or a scientific-technical orientation with an emphasis on major societal risks such as nuclear power, environmental pollution and public safety

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(see, for example, Adams, 1983; Kirby, 1988; Cullen, The Honourable Lord, 1990; Bord and O'Connor, 1990; Horlick-Jones, 1990; Advisory Committee on the Safety of Nuclear Installation, 1991; Lash *et al.*, 1996; Jacobs, 1997). Although the exact nature and definition of the public sector in the UK has changed over time, for example through the growth in the not-for-profit sector and public-private partnerships, the main elements of the sector remain national/central government functions, local authorities and the National Health Service (NHS), and it is these areas which have attracted the majority of attention *vis-à-vis* risk and its management. The nature of public sector risk is, however, much wider than the socio-political and scientific-technical perspectives would suggest. Public entities, whether national or local governments or the NHS, operate within a risk framework which incorporates "macro" risks such as the socio-political, economic, public safety, etc. and the "micro" risks such as property owners' liability, workers' safety, theft, etc. Whilst there are dangers inherent in simplistically categorising these risks, in general the macro risks are likely to be relatively low frequency/high severity events funded from general taxation or contingency funds, whereas the micro risks will be relatively high frequency events which may be of high or low severity and can be funded from a variety of sources. The focus of this paper will be on the management and financing of these micro or operational risks in local authorities.

Significantly, the past decade has seen a shift in focus with much more comment and guidance given on means of categorising public sector risk and on methods for managing it. This reorientation has placed a greater emphasis on the actual methods by which risk management is effectively integrated into the overall management of national or local governmental units. Central government, quasi-governmental organisations and auditing and regulatory bodies have all entered the risk debate, and their various efforts testify to the new emphasis.

One consequence of this change is the significant attention directed to the specific issue of risk financing, especially in local authorities. History shows that until 1992 UK local government relied extensively, nearly exclusively, on Municipal Mutual Insurance (MMI) to provide coverage against risk. After MMI's demise, a thin but seemingly adequate commercial market emerged, only to become itself imperilled by a turn in the underwriting cycle, the collapse of investment returns, and a host of other problems all converging in late 2001 (see Young and Fone, 2002). An illustrative example of this which is particularly relevant to UK local authorities as significant employers is Employers' Liability (EL) (often known as Workers' Compensation) cover. This form of insurance has had worldwide difficulties. The problems in this area have come about due an increase in both the number of claims for work-related injury and illness and in the monetary value of these claims. Insurance has long been the predominant means of financing this form of operational risk, but it has faced a crisis in recent years. Many stakeholders in the EL insurance market (see Association of British Insurers, 2002a, b, 2003; Department for Work and Pensions, 2003a, b; Office of Fair Trading, 2003; Trades Union Congress, 2003) have expressed concerns about, and offered solutions for, the difficulties and long-term sustainability of this risk financing mechanism. Due to the combination of overly aggregated industry statistics, commercial confidentiality and lack of data from local authorities, it is impossible to present hard evidence of the current scale of EL claims and payouts by local authorities. The evidence from the literature referred to above would suggest, however,

that they are likely to be, at least, as badly affected by the market crisis as any other purchaser of the cover.

The recent commercial market difficulties, combined with the none-too-distant memory of MMI's collapse, have produced a growing interest in alternatives to insurance, with interest most keenly fixed on risk pools. Such interest, however, raises a number of questions about form, function, and even legality. This paper traces the factors behind the growing interest in pooling, and specifically investigates the legitimacy of pooling as a public sector option. Additionally, key developmental issues are identified and addressed.

Public sector risk management

During the 1990s there was evident growth in both the interest in and practice of public sector risk management. No significant single event created this interest, but possible contributory factors were (see Hood and Kelly, 1999):

- risk-related issues arising from public enquiries such as Kings Cross and Dunblane;
- the move to risk-based health and safety legislation;
- changes in the public sector insurance market, especially that related to local authorities;
- the growth of the Private Finance Initiative; and
- the fact that many aspects of risk management squared with the tenets of "New Public Management" (Hood, 1991).

This interest in public sector risk management has continued, with an increase in empirical research into its operational aspects (see, for example, Dowlen, 1995; Vincent, 1996; Harrow, 1997; Hood and Kelly, 1999; Hood and Allison, 2001; Hood and McGarvey, 2002).

The rise in academic interest in the topic has been accompanied by a considerable number of central and local government guidance documents on various aspects of risk management. Examples include, innovation (National Audit Office, 2000), procurement (Department of Trade and Industry, 2000), risk assessment (Interdepartmental Liaison Group on Risk Assessment, 2000), risk management in housing (Housing Corporation, 2001; Employers in Voluntary Housing, 2001), as well as more general risk management guidance (HM Treasury, 1994; Accounts Commission, 1999; Department of Culture, Media and Sport, 2000; Cabinet Office, 2002). Although some government interest in risk management predates the 1997 general election, it is plausible to see this as, at least partially, a development that is influenced by the Labour "modernisation" agenda. What, however, does central government and its ancillary bodies actually mean when they refer to risk and risk management?

The term "risk management", as related to both strategic and operational functions, has its origins firmly rooted in the private sector. It has been persuasively argued (Snider, 1991; Grose, 1992) that the modern origins of risk management can be traced from developments in technology and business that occurred during the 1950s and 1960s. Snider, in particular, identifies changes in the risk transfer market, mainly insurance, as being highly influential. As will be discussed, similar changes in the

1990s have had a significant impact on the development of risk management in local authorities.

Earliest definitions of the concept also reveal these private sector origins. For example Dickson (1989, p. 2), defines risk management as:

> The identification, analysis and control of those risks, which can threaten the assets, or earning capacity of an enterprise.

Whilst such a definition succinctly encapsulates the risk framework for commercial enterprises, it does not address the wider socio-political, non-commercial and service-related risks to which public sector bodies are exposed. HM Treasury (1994, 2001) and the National Audit Office (2000) have suggested definitions that, although still applicable to the private sector, take cognisance of the types of risk unique to the public sector. The most recent, and most comprehensive, government attempt to define and explain the importance of risk management in the public sector has come from the Cabinet Office Strategy Unit (Cabinet Office, 2002). Although this document is aimed mainly at central government functions, it is explicitly stated (p. 7, section 1.18) that:

> . . . many of the issues discussed will also be relevant to the wider public sector, including regional and local government.

The Strategy Unit's report makes no attempt to force the public sector to become more like the private sector in its approach towards risk management, but there is a strong theme of private sector superiority running through the document (see, for example, p. 18, section 3.16). Whilst the Strategy Unit's assertion may have some basis in fact, it is silent on the very large number of cases where private sector organisations have palpably failed to manage significant risks (e.g. Railtrack, Barings Bank, Enron, etc.). Although, therefore, a case can undoubtedly be made for a more comprehensive and systematic approach to managing public sector risk, the words of caution expressed by Hood and Rothstein (2000, p. 30) on the uncritical adoption of business risk management techniques by the public sector should not be ignored:

> Business risk management is emphatically not a panacea for solving all the intractable polyvalent policy problems faced by government (sometimes referred to as "wicked problems"). Nor is it something that can effectively be done by numbers in an unreflective way. Top business leaders often stress that risk management is an art and a craft. And in some conditions, as argued earlier, risk management procedures could unintendedly exacerbate blame-avoidance tendencies in public bureaucracies. Achievable successes are likely to be limited and in the middle range. But as was suggested earlier, intelligently applied business risk management approaches have the potential to increase public value by helping to ensure continuity and quality of public services.

Young (1996) argues a version of this cautionary view, asserting that public sector risk management is differentiated from business risk management owing to goal differences (fairness versus efficiencies), budgetary objective differences (stability versus profit maximisation), and differences in the nature of the risks themselves (public versus private risks). In short, whilst public and private sector risk management have many fundamentals in common, the contexts and purposes are appreciably different.

Therefore, with respect to a definition of risk management in the public sector, Fone and Young (2000, chapter 1) indicate that risk management is:

> . . . a general management function that seeks to assess and address risks in accordance with the overall objectives of the organization or entity.

This somewhat elastic definition contains three implicit features:

(1) risk management is a general management function, meaning that while there may be people called risk managers within an organisation, risk management nevertheless is something all managers do within the scope of their responsibilities;

(2) the definition takes the broadest possible view of the risks that should be managed, and

(3) the approach to assessing and addressing risks is consciously driven by the overall purposes of the organisation in question.

With respect to the final point, public entities manage risk to assure stability, equity and fairness, and the accomplishment of other public purposes.

Risk financing in local authorities

The public/private differences noted previously have an important influence on risk financing. In one sense, government itself is a form of insurance in that public resources are pooled to address common needs. Philosophically, this raises an important question about how governments finance risk because in principle the power to tax is the power to distribute the cost of risk. This assertion, of course, is constrained in reality by actual taxing capacity and authority, political influences, and a host of other practical considerations. However, it does suggest that transferring risk to other parties is a measure that should be undertaken only to the extent that the government is unable to bear the risk itself (Young, 1988).

That this does not much happen, except in central government, which views itself as large enough to retain and bear most of its risk, is one of the interesting discoveries arising from the reorientation of public risk management research (Young, 1997). Many of the risks that authorities face, particularly those associated with their legal liabilities and their significant property portfolios, are financed at least in part through risk transfer to the insurance market. The economic case for insurance of risks other than those that could be categorised as "catastrophic" has been a subject of some debate (Gollier and Pratt, 1996; Gollier, 2001, 2003). Nevertheless, local authorities rely on commercial insurance markets, in principle at least, to a greater degree than one might expect. So, the question reasonably may be asked, why do local authorities buy insurance? The answer is revealing. Theorists, who otherwise conclude that reliance on insurance in the long run is economically flawed, accept that the risk aversion of the purchaser is a dominant factor in the buying decision. In effect, the subjective concerns of the risk-averse organisation will subjugate any objective assessment of the true economic value of insurance. Given that local authorities are traditionally perceived as being risk averse, it should be of little surprise that they have tended to rely heavily on insurance (Young and Smith, 1995). One could therefore argue that local authorities have historically relied on commercial insurance because of risk aversion, a need for budgetary stability (insurance serves as an off-budget shock absorber), limited to no capacity to tax directly as a substitute for insurance, and general conservatism. The unwillingness of public authorities to experiment with alternative risk transfer

innovations that emerged in the 1990s (weather bonds, derivatives, hedging, capital market devices), as was occurring in the private sector, seems to underscore this philosophical orientation. Importantly, however, there also was a widespread view in the 1990s that many alternatives to insurance could be *ultra vires* and therefore illegal.

Fone and Young (2000) offer a different insight on UK local authority reliance on insurance, suggesting that this reliance on the insurance market (in particular, on the predominant company for local authority business) was in fact a barrier to the development of risk management within authorities. The company involved, Municipal Mutual Insurance (MMI), was, as its name suggests, owned by its policyholders, i.e. local authorities. Until the late 1980s it provided insurance for approximately 90 per cent of local authorities. Fone and Young (2000) argue that this market dominance provided authorities with an insurance "comfort blanket" that protected them from the commercial realities of the market place. MMI provided insurance at rates that were, ultimately, unsustainably low and had a very relaxed attitude to policy interpretation, i.e. they paid for losses that were technically not covered under the terms of the policy. For a variety of different reasons, MMI was forced to cease trading in 1992 (Young and Fone, 1996) and its business was acquired by the Zurich Insurance Group and re-branded as the Zurich Municipal Insurance (ZMI). It is not appropriate here to closely analyse the differences between the approaches of MMI and ZMI, but suffice to say that the latter took a much more commercial attitude to local authority business, encouraged authorities to develop risk management initiatives and forced them to bear a sizeable proportion of the likely cost of risk themselves.

It will be useful to note that Young and Fone (1996) contend that MMI's unintended suppression of risk management had a further roundabout influence on risk financing. Problems with the cost of risk financing may have been influenced by the trials and tribulations of the commercial insurance market, but they believe that the underlying problem is the inherent riskiness of governmental entities. Governments are engaged in highly risky activities – policing, public health, safety and security, emergency response – and that fact places a premium on the need to practise risk management. So, MMI may have influenced the level of risk management being practised, but the absence of risk management practices also led to the growing riskiness (and rising claims costs) of local government.

It has been observed that the demise of the MMI contributed to a significant rise in the wider function of risk management within local authorities (Hood and Kelly, 1999). Despite this, heavy reliance still has been placed on the purchase of insurance as a risk financing mechanism, albeit from more than one insurer – at least until very recently.

As indicated previously, this situation has been undermined by the commercial reality of the insurance market, what is generally referred to as the "insurance cycle". Within this cycle there are fundamentally two positions – the "soft market" and the "hard market". Soft market conditions are such that insurance company capacity is high and premiums are relatively low. Invariably these conditions result in underwriting losses for the insurers, which leads to a sudden swing to hard market conditions, i.e. low capacity, restrictive terms and conditions and high premiums. The market conditions have been hard for some time, a situation exacerbated by the terrorist attacks of September 11, 2001, by the collapse in investment returns in 1999,

by financial management difficulties, and by legacy problems such as asbestosis claims.

The insurance market conditions, particularly for certain types of cover, have become a concern for government (Department for Work and Pensions, 2003a, b) and insurance trade associations (Association of British Insurers, 2002a, b, 2003), as well as for public sector purchasers of insurance (Home Office Active Community Unit, 2003). Local authorities in particular have found themselves in a situation whereby their predominant means of financing risk has become, at best, highly problematic, or, at worst, unavailable. This situation is ultimately untenable in an era of value for money, local government accountability, and constraints of raising finance, but historically the options available to local authorities have been extremely limited. There is some evidence, however, that the "innovation" and "modernisation" agendas, as well as recent legislative changes, may provide authorities with a risk-financing alternative to insurance. Paradoxically, this development may see the risk financing function that traditionally has been outsourced, outsourcing being a key aspect of modernisation, being brought back in-house, albeit in a specific form.

Risk financing pools

Risk financing pools in both private and public sectors worldwide are not new, with some governmental pools in Japan, the USA, and The Netherlands having their origins in the 1940s and earlier (Young *et al.*, 1999). In the UK, these types of organisations are generally referred to as "mutuals", i.e. they are owned by their members, who in turn utilise their services. In mutual risk pools the risks themselves are not being shared, but the negative financial consequences of these risks coming to fruition are.

There are a number of different types of risk pools, with the late MMI being one of these. This particular type is known as a "guaranteed indemnity mutual" (GIM), and the nature of these mean that they must comply with strict legislation and regulation regarding the transaction of insurance business. GIMs are, in effect, insurance companies and would be subject to substantial capitalisation requirements before they could transact business. The Financial Services Authority has, however, allowed certain concessions regarding the solvency requirements of new mutuals when compared to requirements that would apply to joint stock companies.

A second form of risk pooling is one based on the "captive insurance company" (captives) concept. Captives have long been used by private sector companies and can loosely be defined as being insurance subsidiaries that are wholly owned by non-insurance parent companies and that underwrite only that parent's risks. These have generally been based in low tax environments such as Guernsey, The Isle of Man and Bermuda. In the past many UK companies were attracted to the captive option by advantageous tax arrangements, but these benefits have diminished in recent years and the major attraction of captives now is that they can economically address insurance market failures, can facilitate the coordination of global risks, and can enjoy some regulatory freedom in working with reinsurance markets. Like GIMs, captives are required to meet capital and solvency arrangements of their domiciles. These requirements may be less onerous than those of the UK. The variation on the captive theme that, theoretically, is most relevant to local authorities is the protected cell captive (PCC). The PCC is a single legal entity, but it consists of individual protected cells that are segregated and have legal protection from the creditors of other cells. In

effect, each cell is analogous to a separate limited company that benefits from the economies of scale enjoyed by the cumulative whole of the PCC entity. There is no central register of UK members of PCCs, but it is believed that the public sector has not utilised this form of risk financing. Again the question of *ultra versus intra vires*, allied to regulatory and solvency requirements and the political acceptability of utilising what are perceived to be "tax havens", may have militated against their use.

A third type of pool is the "discretionary mutual" (DM). DMs provide a form of quasi-insurance that is not legally enforceable, i.e. the mutual has the discretion as to whether or not it will pay for losses. This element of discretion removes the DM from the legislative and regulatory regime to which GIMs are subject. A number of DMs exist in the UK, e.g. The Medical Defence Union, The Medical Protection Society and The Universities' Mutual, although it has to be recognised that the individuals and groups forming these risk pools have not, historically, been subject to the same strict statutory regulation as local authorities.

In principle, therefore, there appears to be both a *prima facie* case for local authorities considering a GIM or a DM and a public sector precedent in the form of NHS experience.[1] Why, therefore, has there been no apparent move from local authorities in this direction? The predominant reason is believed to be the legal status of local authorities and, in particular, the need for everything that they do to be *intra vires,* i.e. under powers that are vested in them by statute and other central government regulation. The courts have had a tendency to apply a very narrow interpretation of this concept, and in the context of risk pooling, local authorities – if they thought about it at all – would almost certainly have considered pooling to be an *ultra vires* use of local rate-payers' money. Notwithstanding any initial cultural or organisational barriers to risk pooling, the fact that it was considered to be *ultra vires* resulted in it being something of a dead issue.

However, the legislative situation has recently changed. The Local Government Acts (LGAs) of 2000 and 2003 (affecting England and Wales) and the Local Government in Scotland Act 2003 could be interpreted as being more flexible in their approach to local authority powers. For example, section 2 of the LGA Act 2000 – the well being powers – states:

> . . . that every local authority are to have the power to do anything which they consider is likely to achieve any one or more of the following objects:
>
> (1) the promotion or improvement of the economic well being of their area
>
> (2) the promotion or improvement of the social well-being of their area, and
>
> (3) the promotion or improvement of the environmental well being of their area.

Second, the LGA 2003 has:

- granted local authorities the power to trade in relation to statutory functions;
- made it easier for local authorities to invest in capital projects (the Prudential Code); and
- eliminated many of the restrictions that previously applied to the power to borrow.

The specific issue of risk pools has not been legally tested, but it is interesting that the Cabinet Office report (2002, pp. 37-8), which has already been identified as being relevant to local authorities, is explicit on the topic:

> We recommend that the Treasury should consider running a pilot of the use of captive insurance arrangements in government.

This strong endorsement of the concept, the potential for pools to be a legal option for local authorities, the positive experience from both the UK and overseas and the ongoing inefficiencies of the insurance market would suggest that the feasibility and financial viability of risk pools be explored. And, indeed, as of May 2005, there are at least two major initiatives underway in the UK to develop risk pools[2]. Given that this is now very much a live issue in local authority risk financing, we will now discuss the nature of pools, the options available to UK authorities and the advantages and disadvantages of the concept.

Pooling in the US: an instructive digression

Undoubtedly, the UK and the US are not much alike when comparing local governments. Perhaps most notably, US local governments are creatures of state governments and this means that summarising statements about pools are difficult (however, see the Appendix for a brief overview). Further, local governments are, on average, much smaller than UK local authorities (a point that will be explored below). Indeed, most pooling participants have populations below 10,000 and the vast majority of those have populations of less than 2,000.

Nevertheless, the general experience of pools in the USA does offer some insights that seem relevant to the UK situation. These insights might be aggregated into five categories, as discussed below.

The Law of Large Numbers favours homogeneity

Whether by necessity or design, almost all pools in the USA have a homogeneous membership. There is a common logic at work, of course. Local governments that are similar will have similar issues and problems and will tend to work together. However, there is an "insurance" logic at work as well. Pooling homogeneous exposures tends to produce more statistically credible estimates of future claims. It is, in fact, the similarity of exposures that assures a level of fairness and equity to the risk-sharing proposition (Young, 1988).

In the UK, the issue must be slightly reframed. Local authorities are, on average, much larger than pool participants in the USA. One might reasonably wonder whether a collection of, say, county authorities, would be too heterogeneous to obtain any advantage from pooling. This could be true, if exposure to risk were the only consideration (rural and urban counties have different exposures to risk). However, this concern might be addressed by noting that:

- pooling members could choose to only share the risks that they have in common – say employers liability; and
- homogeneity does not establish a size criteria *per se*, it is more a matter of "capacity to bear risks".

A large authority with little or no ability to tax or raise capital may actually have less ability to bear risk than would a smaller entity – and therefore might derive benefit from pool participation.

Prohibition on the commingling of funds was the biggest legal barrier to pool formation
When US pools began to form in the 1970s, numerous administrative and organizational obstacles and difficulties presented themselves. Fortunately, many of these issues were resolved by virtue of the fact that intergovernmental cooperation had become an important development of the period, for example through councils of governments, regional transit authorities, water management districts, etc. However, the nature of pooling led to a specific problem that could only be solved through legislative intervention – the commingling of public funds. In previous collaborative ventures, public funds may have been committed to a joint authority, but the benefit was construed as falling to all participants. With risk pooling, the benefit accrues to those entities suffering claims. This transfer of funds from one authority to another was strictly prohibited under state statutes, and until the legislatures eliminated that prohibition, it meant that pooling was not possible (Young, 1988). This issue is similar to *ultra vires* restrictions in the UK, but there is a distinct philosophical dimension that is, perhaps, less obvious to UK local authorities. If pooling were determined to be *intra vires*, local authorities would have to be politically and administratively comfortable with the fact that their funds were paying for the claims filed by other communities. And, as proved to be the case in the USA, pool participants would have to understand the importance of establishing membership and underwriting standards within the pool. It is one thing to transfer funds to a neighbouring community for a completely fortuitous event – a fire to a community facility, for example. It is quite another to be consistently supporting the cost of claims arising from poor management practices – discrimination claims, police liability, etc.

Focusing only on financing produces numerous conceptual, regulatory and legal issues
Demarcation lines between the public and private sectors are notoriously contentious in the USA, especially since the early 1980s. In such a climate, there have been numerous challenges as to whether pooling is an essential public service or is just an example of "public entities mucking about in private markets". Do governmental entities have any business competing with commercial insurance companies?

The fierceness of this debate ebbs and flows with commercial insurance market conditions: when the market is soft the arguments are intense, and when the market is hard silence prevails. As a matter of defence, the pooling community has evolved two basic arguments. The first is that commercial markets are fickle for public entities and that stability is an essential feature of public financing. Therefore, periodic robust markets are not evidence of demand being met (this is the "market failure" argument). The second is that pools are not insurance organisations – they are risk management organisations. As pools have evolved, they have tended to adopt the view that they are the risk manager of their members, not the insurer of the members. This assertion must be made with some caution because numerous pools do continue to view themselves as – more or less – insurance companies. But, the argument that pools are direct competition for commercial insurers is lessened the more pools define themselves as risk management entities (Young and Reed, 1995).

Adequate service markets exist to sustain pooling
US pools have owed much of their success to the growth of commercial pooling services markets. To a great degree, a pool can acquire every technical service conceivably needed to operate: actuarial and audit services, claims and underwriting services, broking services, training and management services, excess and reinsurance services, and more. In the USA, there is some debate over the chicken-and-egg nature of this phenomenon. Did the presence of these services enable pools to form, or did the formation of pools lead markets to form to support their growth?

The debate may never be resolved, but the strong presence of these service providers, which, incidentally, frequently are traditional insurers and brokers in repackaged form, is a signal that pools are a long-term phenomenon and that commercial markets have adapted to their presence (Young and Fone, 2001).

Pools, properly conceived and executed, can dramatically improve the quality of risk management in member communities
Pools in the USA argue that they have solved the problem of risk financing for local governments. There is some contention over whether they can lay claim to victory, but it is – among pool participants anyway – accepted that pools have been instrumental in improving risk management practices within member entities. Even in situations where a pool is not providing risk management services, the heightened awareness of the link between risks and the cost of risk seems to serve as a motive for the adoption of risk management practices (Young, 1994).

Discussion and summary

From the evidence, it appears that even if legal or regulatory barriers to pooling in the UK previously existed, these have now been removed or, at least, significantly reduced. This development can be placed firmly in the context of modernisation and innovation that has come to characterise the crux of central government's approach to the public sector as a whole. However, there does appear to be some distance between legality and feasibility. As the US experience indicates, the growth of pools enjoyed certain windfall benefits by virtue of the fact that there was virtually no commercial insurance market for public entities and therefore no competitive threats for pools. Favourable tax and regulatory treatment gave pools a distinct cost advantage, and the rather loose-jointed system of federal government in the USA allowed states and localities within states to innovate and experiment. It does not seem that any of these conditions entirely hold in the UK. There still is a commercial insurance market, albeit limited in terms of choice and capacity. The existence, *per se*, of such a market does not, however, significantly ameliorate the volatility that has come to characterise local authority risk financing. There are also no special statutory privileges for pools (though discretionary mutual rules rather closely mimic some pool enabling statutes), and the relationship between central and local government in the UK suggests that relatively standard approaches would have to be employed.

Still, the main obstacle to further discussion of pooling has been the question of legality, the *intra/ultra vires* issue, which appears now to be resolved in favour of pooling. There is significant activity underway in England and Scotland indicating that interest in pooling has led to feasibility studies, conferences, and task forces all examining the viability of pooling. Further, as was mentioned previously, other general

local government conditions – especially the emphasis on improving quality, the reliance on outsourcing, and the emergence of risk management as a public sector issue – are adding some fuel to the fire. These factors, largely absent in US experience, could override the presence of commercial markets, the lack of regulatory and innovation advantages, and lead to continuing interest in, and development of, pooling in the UK.

Finally, the rather overwhelming development of pooling in the USA leads to a rather obvious conclusion, which is that pooling seems to work. The early years of pooling development (the 1970s-1980s) saw numerous conceptual and legalistic challenges to pooling, such as "Governments have no business competing with commercial markets", "Governments are incapable of running businesses like insurance", "Financial viability is not possible", "Self regulation cannot work". The 30-year history of pooling, with over 500 pool funds in operation, has produced a detailed and substantial body of evidence to refute each argument. Only a very small number of pools have ceased operation over the past 30 years, and typically by choice, not necessity. So, while the question "Should pooling be developed in the UK?" cannot be answered here, the question "Can public sector pooling work?" can. Adoption of pooling in appropriate circumstances, provided the actuarial, financial, managerial and operational approaches are satisfactory, is likely to yield both financial and operational benefits for local authorities. They will be released from the vagaries and volatility of the commercial insurance market, which, in reality, has only a limited appreciation and appetite for the risks authorities face. In addition, the US experience suggests that pools rapidly develop simply from being providers of risk financing to conduits through which risk management guidance, initiatives and good practice are channelled. Any concomitant reduction in risk following from this will not only reduce the financial liability of the authorities, but also benefit citizens through the better use of resources.

Notes

1. See the 2002 report "Coordination of reviews of risk management in NHS Bodies in England and Wales", published jointly by The Audit Commission, The Commission for Health Improvement, The National Assembly for Wales, The Department of Health, The Health and Safety Executive, The NHS Litigation Authority and The Welsh Risk Pool, for an explanation as to the role of risk pooling in NHS risk management.
2. For example, it is known that 15 (out of 32) Scottish local authorities are exploring the possibility of risk pooling. In England, 20 metropolitan authorities have commissioned a pooling feasibility study, with an expectation that the pool will form in the latter months of 2005. For reasons of commercial confidentiality, they are unwilling to discuss these exploratory studies at this stage.

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Appendix

Although the history of pooling is lengthier in Japan, US experience is far richer. Based upon data maintained by the Association of Governmental Risk and Insurance Pools (AGRIP) in the United States, there are over 500 pool funds currently in operation. Possibly as many as 60,000 local governments (out of 84,000) participate in pools, and the aggregate contribution volume is variously estimated between $US7 and $US10 billion.

There is a wide range of pooling models and it sometimes is more telling to discuss the differences rather than the similarities. However, a few descriptive facts can shape the general picture (see www.agrip.org).

- Almost all pools are highly homogeneous as to state, type of entity, geographic location (within a given state), and size of entity. So, for example, a township pool would contain only townships from a particular region within a single state and those members would be very similar in size and form.
- Many pools are sponsored by public sector associations such as leagues of cities, county associations, and school district associations. Many, however, were started by the local governments that then became pool members.
- Although individual pools offer limited ranges of coverage (only property, only workers' compensation, for example), taken as a whole the pooling community offers almost all coverages offered by the commercial life and non-life insurance industries.
- Pools (with only a few exceptions) are not viewed as insurance companies and thus are not subject to the rules, laws and regulations that apply to commercial insurers. This is a somewhat controversial feature since from time to time pools compete for business with

commercial insurers and the pools' special status gives them a significant potential pricing advantage.

- Pools mainly are authorized as joint powers agreements that are authorized by state governments, but fashioned by participating local governments.
- While most pools were formed to address insurance unavailability and unaffordability, a sizable number of pools have evolved into more than just a provider of coverage. They may be more accurately described as "risk management pools" because they provide training, loss control services, consultative services and a range of technical risk management assistance.
- Very few pools have discontinued operations, and those that have revealed problems due to poor management, and technical problems in operations. Failures have not been seen as evidence of fundamental problems with the concept of pooling.