**STRUCTURED SETTLEMENTS WORKING PARTY**

*This paper considers the possible application of structured settlements in personal injury compensation. We consider the advantages and disadvantages of alternative methods of compensation. We outline a prospective view of potential future developments both from the perspective of individual claimants and defendants (usually an insurer).*

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## Summary

This paper is being prepared in a rapidly moving landscape of changing personal injury compensation. The Wells, Page and Thomas Judgement (Wells judgement), the Woolf reforms and Lord Chancellor's Consultation on the discount rate for personal injury compensation are all significant recent developments. At the time of writing, the Lord Chancellor's response to the initial consultation has not been made public.

In March, the Institute and Faculty hosted a seminar entitled "Damages Seminar – An Alternative to Lump Sums". At this seminar a motion was debated that "The needs of victims and society would be better served by courts having the power to make income or benefit settlements. This would be more effective than awarding lump sums." The vote in favour was almost unanimous.

The Wells judgement relates to the appropriate level of investment risk that is deemed reasonable for an individual claimant. In the Wells judgement, the House of Lords adopted a conservative approach (index-linked gilt yields) to investment returns as compared to a pooled investment basis. The rationale for this is that an individual claimant is in a more vulnerable position than a collective. As the risks faced by claimants become better understood by the Courts, it is likely that the basis of lump sum compensation for future losses will become more costly to defendants.

This paper addresses the issues affecting damages for future loss of earnings and cost of care for large cases. The principal objectives of the paper are as follows:

- To summarise the principles underlying current UK compensation
- To comment briefly on recent developments in the UK
- To define structured settlements and their current and potential role in the UK
- To summarise the application of structured settlements in a number of other countries
- To consider the future development of the UK compensation system.

We see a requirement for Courts to prescribe fixed structured settlements in appropriate cases as a necessary development. This will require an Act of Parliament. This is likely to lead to cost savings for defendants. We see structured settlements as a substantial improvement but in the long term the framework is likely to become more sophisticated incorporating rehabilitation and reviewable settlements.

The working party has to acknowledge the contributions of earlier working parties and Jonathon Yates who kindly provided notes which have formed the basis of much of the detailed comment on structured settlements. We have assumed a certain level of knowledge in writing this paper and interested readers are referred to last year's GISG Bodily Injury Claims paper. The opinions expressed represent the views of the members of the Working Party.

## 1 Principles of UK Compensation

The general principle underlying settlements for damages is *restitutio in integrum* – that the claimant shall be restored as far as possible in money terms to the position that applied before the accident. The interpretation of this principle has largely been left to the Courts. However, the Damages Act 1996 made the Ogden Tables admissible as evidence and provides the Lord Chancellor with the power to specify the interest rates to be applied to determine lump sum compensation.

In practice, the principle of *restitutio in integrum* is subject to contributory negligence, hence liability compensation takes of account of fault and may be reduced to allow for the proportion of the claim that the claimant is at fault. For example, if the Court decides that a claimant is 25% responsible for the accident causing their injury, the defendant is deemed to be only 75% liable and total award is reduced accordingly. In this paper we discussed damages assessment in the context of full liability or prior to any reduction for contributary negligence.

Appropriate levels of compensation are amounts that are deemed to be fair and reasonable having regard to precedent. Compensation for loss of earnings and care costs are estimated using specified assumptions so as to reflect the claimant's perceived loss. The basis used for calculating future losses has changed from rule of thumb multipliers to a more explicit basis using the Ogden tables. This is a reflection of growing sophistication in the general approach to setting damages.

Over time, perception of appropriate levels of compensation for general damages (effectively pain and suffering and loss of amenity) changes. The tendency is for such compensation to increase in the UK. Two of the main influencing factors are probably higher wealth levels and public awareness of large settlements.

A further influence affecting claim costs is the effect of the State sector seeking to recover its costs. This is effected through changes in the legislative structure. The recent increases in NHS claw-backs for the treatment of accident victims is an example.

The general principle underlying the calculation of the lump sum award for future loss of earnings or costs of care is the application of a multiplier which represents an annuity factor to a multiplicand representing the notional annual amount of the loss. The multiplier is supposed to reflect investment returns, inflation and mortality risks. In Appendix A, a summary of the principles underlying the assessment of damages in liability claims is set out.

Structured settlements are tax free provided they fall within parameters that are approved by the Inland Revenue. Broadly, a structured settlement will be approved if it is sanctioned by the Court as part of a compensation award. This is only possible with the agreement of both the defendant and the claimant. An annuity purchased by a claimant with a lump sum award will not be approved and is therefore subject to tax in the same way as any puchased life annuity. Part of the income resulting from the annuity is deemed to be a return of capital and is exempt from taxes.

Under UK law, there is scope for the payment of provisional damages when there is a significant uncertainty over the degeneration in a claimant's condition at the date of judgement. The provisional damages are awarded on the basis that the claimant will not suffer the potential degeneration. However, the claimant may be paid further damages at a future date within a defined timeframe, if he or she suffers the specified potential degeneration. The claimant may subsequently apply to the Court for an extension of the time-frame. Only the claimant can apply for a provisional damages award.

## 2 Structured Settlements

"A structured settlement is the payment of money for a personal injury claim where at least part of the settlement calls for future payment. The payments may be scheduled for any length of time – usually as long as the claimant's life – and may consist of instalment payments and/or future lump sums. Payments can be in fixed amounts or they can vary. The schedule is structured to meet the financial needs of the claimant."[1]

Typically, a structured settlement will involve the defendant's insurer purchasing an annuity from a life office to discharge its liability to the claimant. In the UK, all structured settlement cases to date have involved personal injury cases. In most of the cases, the extent of the injuries has been considerable and there has often, but not always, been a significant reduction in the life expectancy of the claimant.

The life office undertakes extensive medical underwriting and provides an impaired life annuity, usually on materially better terms than would be available for standard annuitant lives. The underwriting undertaken by the life office is a highly specialised task and can be very detailed and time-consuming. In the USA, it is common to structure types of claims other than personal injury cases and, in these cases, limited underwriting is undertaken as appropriate.

In the UK, if a structured settlement is set up under an approved "model agreement", the total annuity payment will be received tax-free in the hands of the claimant. This required a change in the law, which was introduced in the late 1970s, and means that both the annuity purchase price (the lump sum cost to the defendant) and the investment income reflected in the annuity are tax-free.

Prior to the Finance Act 1995, it was an Inland Revenue requirement that all purchased annuity payments should be made to the defendant (insurer) who then passed on the payment to the claimant. This requirement no longer exists and the life office writing the structured settlement may make direct payments to the claimant.

This compares with a lump sum settlement where only the lump sum is tax-free and any investment income earned subsequently is taxable. For a settlement to be structured, both claimant and defendant must agree to this approach. Defendants have used this as a means to persuade claimants wishing to structure to "share" the value of the tax benefit to reduce their overall costs. However, the practice seems to have disappeared following the Finance Act 1995 because prior to this the defendant would have to keep its books open to administer payments under the structured settlement. The defendant would seek a discount to meet these costs.

[1] Source: National Structured Settlement Trade Association (USA)

It was not until the late 1980's that the first structured settlement annuity was written in the UK. Since then, the insured market has developed slowly and appears now to have reached around 200 cases each year. It appears that only in a small number of cases do claimants and defendants consider structured settlements a worthwhile solution.

This picture contrasts sharply with the USA, where the market has developed strongly since the 1970s. Around 50,000 cases are structured each year with a value of US$5 billion, representing around 5% of all casualty settlements. The average case size is around US$100,000, but cases that settle for as little as US$10,000 can be structured.

***Types of Structured Settlement***

Common variations of structured settlements include:-

- Level or escalating payments at fixed rates or matching RPI
- Various payment frequencies as appropriate
- Various start dates
- Ceasing on death or the expiry of a fixed term
- Guaranteed periods, for example payment for 5 years even in the event of the death of the claimant during the guaranteed period.

Structured settlements may be determined on the basis of a "bottom-up" or "top-down" basis. The "bottom-up" basis is when the structure is defined in terms of the needs of the claimant. The "bottom-up" basis is consistent with the principle of compensating the claimant according to need and therefore fits the principle of *restitutio in integrum*.

"Top-down" structures are based on the principle that the structure is simply an alternative method of paying the lump sum. The payments available are determined from the amounts that can be purchased with the lump sum, and are thus impacted by the state of the annuity market at the time of purchase. The top down approach is less consistent with the principle of *restitutio in integrum*.

***Market size***

Approximately 200 structured settlements per year take place in the UK. The average capital value of these is between £0.50 million and £0.75 million . This results in an indicative range for the current market size of between £100 million and £150 million per year.

We estimate that there are currently around 1,500 to 2,500 bodily injury settlements per annum falling above £200,000. We believe that structured settlements would be appropriate for claims of this size. This provides a potential indication of current structured settlement utilisation of between 6% and 8% by number of cases that could potentially be structured. Using a some-what lower average cost range of £0.3 million to £0.6million, because the cases currently structured are biased towards the largest, the total value of these claims is estimated to be between £0.5 billion and £1.5 billion.

This suggests that if structured settlements were to become standard practice, rather than the exception, the size of the potential market would be sufficient to encourage greater competition in this area. Over time, given the real growth in personal injury settlement amounts, one would expect that the market would grow significantly.

***Insurers***

Structured settlement annuities have been written by a small number of life offices. At various times, different offices have been active in seeking to quote for new business, but the total number active at any one time in the UK has rarely exceeded five. The specialist knowledge combined with the experience necessary to undertake the complex medical underwriting is not widely available. This acts as a temporary barrier to wide-scale entry into the market, although various reinsurers have provided this service to certain offices from time to time.

A further barrier to wider market participation is the current small size of the market. These risks are specialist and the market is a niche sector without mass market competition. It is therefore likely that this business is written and reported on a conservative basis.

It is difficult to see how the market will grow rapidly unless Parliament were to oblige claimants and defendants to consider structured settlements as their first and default option for losses relating to future earnings and the cost of care. Lord Steyn makes this point in the Wells judgement and the relevant comments are set out in Appendix B.

***Intermediaries***

The UK market is still relatively small with around only 200 structured settlement annuities being written each year. Of these, around 80% are placed by Frenkel Topping, a firm of Forensic Accountants who act as independent financial advisers (IFAs), and have played a leading role in developing this market in the UK.

The specialised intermediaries operating in this market are usually attached to forensic accountancy practices. Forensic accountants specialise in advising clients who have suffered loss as a result the actions of another party and illustrating the loss by representing the accounts of the claimant on the basis that the action giving rise to the loss had not happened.

Typically, structuring a settlement can be a complex and possibly lengthy process. The role of the intermediary is to guide the parties through this process, helping them to design a package suitable to the needs of the claimant that satisfies the complex legal and Inland Revenue requirements.

In addition to this, intermediaries have undertaken active lobbying amongst lawyers, politicians, insurance companies and the tax authorities to gain wider acceptance and understanding of structured settlements as well as more favourable treatment wherever possible.

## *Remuneration*

Intermediaries are remunerated on one of two bases (or on a combination of the two):-

### *Professional fees*

These are charged on the basis of time spent and expenses incurred and are analogous to the fees that would be charged by the forensic accountancy practice. The defendant will pay the fees regardless of whether the settlement is structured or not.

### *Commission*

The life office pays a commission to some intermediaries. Commission rates vary widely, but 2% of the purchase price is not untypical. Although the commission paid can exceed what the forensic accountant may have charged on the basis of "time and expenses", it is equivalent to "no win, no fee". If the settlement is not structured, the intermediary will receive no payment. As a result, defendants in cases that are uncertain to result in a structured settlement prefer this approach.

## 3 Comparison of Alternative Settlement Methods

The tables below summarise the advantages and disadvantages of alternative methods of settling claims for large future losses from the perspective of the claimant and the defendant (insurer). Clearly, lump sum settlement is most appropriate for the smaller claims.

Indemnity refers to the situation where the defendant provides indemnification in respect of future costs by meeting expenses and paying costs as they become due. As for structured settlements, general insurers would probably wish to "buy-out" such liabilities although such a product is currently unavailable.

The tables refer to risk in general terms of uncertainty. It should be understood that the claimant may actually benefit from accepting risk. The +'s and –'s represent advantages and disadvantages respectively. For this purpose, bearing risk is considered to be a disadvantage although the claimant could benefit financially from acceptance of the risk.

Table 1: Claimant perspective

| Issue | Lump Sums | Structured Settlements | Indemnity |
|---|---|---|---|
| Maximum flexibility | + | - | - |
| Dissipation risk | - | + | + |
| Adequacy risk | - | - | + |
| Mortality risk | - | + | + |
| Investment risk | - | + | + |
| Inflation risk | - | -/+ | + |
| Default risk | + | + | (+) |

From the claimant's perspective the main advantage of a lump sum settlement is that it provides an immediate cash benefit for the estimated total loss. This provides the claimant with maximum flexibility. Under the alternatives this advantage is lost, although structured settlements can be altered to vary claim payments to meet specific requirements of the claimant.

Dissipation risk relates to the risk that the claimant dissipates the award well in advance of needs. Alternatively, the claimant could under-spend and unnecessarily compromise quality of life. In the event of dissipation, the State will end up bearing the additional costs arising from the misjudgement or choice of the claimant. A structured settlement reduces this risk substantially. Dissipation may also come through the hands of unscrupulous or unskilled relatives.

Adequacy risk refers to the risk that the compensation paid may be more or less than the claimant's actual needs. The only way to eliminate this risk is through an indemnity mechanism or reviewable structured settlements. Fixed structured settlements do not address this problem. The budget and the schedule of payments is generally fixed at outset. In the rare event of a provisional award, there would be provision for review at a specific point.

Mortality risk refers to the risk that the claimant may live for a longer or shorter duration than the basis of the award. Under a structured settlement, this risk is transferred from the claimant to the underwriting life office. For an indemnity award the risk would stay with the defendant, unless a "buy-out" was effected. Another aspect of the mortality risk is the return of capital in the event of early death. A number of structured settlements provide a guaranteed income for a limited period to address this point. However, a lump sum settlement leaves the claimant's relatives in the best position with respect to this risk.

We have analysed mortality risk for male and female annuitants aged respectively 20, 30, 40 and 50 using mortality tables ELT15, from which the latest Ogden tables were derived. The table shows values at a 3% interest rate. More extensive results including different interest rates are included in Appendix D. The analysis is on the basis that the experience is exactly in line with the assumptions.

The results show that the inequities of lump sums are highly dependent on life expectancy for a given interest rate. Older claimants are subject to the highest degree of inequity because the prospective mortality error is highest for these claimants. There is also a variation caused by the interest rate. The shortfalls are greater the lower the interest rate.

The following table shows the deficits and surpluses experienced by the 5% longest and shortest survivors. In addition, the average deficit of the claimants who are worse off and the average surplus of the claimants who die in advance of the term of the annuity is shown . The distribution is skew with fewer, higher surpluses as compared to lower deficits affecting more individuals. The surpluses and deficits are quite marked. It should be borne in mind that this analysis relates to only one dimension of the potential variability faced by lump sum recipients. Hence, in practice, the scale of variation is far more significant.

Table 2: Inequities caused by mortality risk: 3% Interest rate

| Age | 30 Male | 30 Female | 50 Male | 50 Female |
|---|---|---|---|---|
| **Deficit analysis** | | | | |
| Deficit of 5% longest survivors | 19% | 15% | 42% | 33% |
| Average deficit of claimants worse off | 9% | 8% | 20% | 16% |
| % of claimants with deficit | 62% | 64% | 58% | 61% |
| **Surplus analysis** | | | | |
| Surplus of 5% shortest survivors | 52% | 45% | 76% | 71% |
| Average surplus of claimants | 16% | 14% | 28% | 25% |
| % of claimants with surplus | 38% | 36% | 42% | 39% |

Investment risk refers to the risk that the investment return achieved by the claimant falls below the anticipated basis of the award. The Wells judgement shifted the balance of this risk towards the claimant, on the basis of escalation of payments in line with RPI. However, strong arguments could be advanced that RPI is insufficient to match earnings and medical cost inflation. The lump sum short-fall in current awards for a 30 year old woman would be approximately 27% for a 1% under-statement of investment return.

Inflation risk refers to the risk that the escalation of costs may exceed the basis of the award. A structured settlement that is based on a specified inflation basis does not eliminate this risk completely because the claimant's costs may inflate at a different rate. However, the risk is reduced compared to a lump sum settlement.

Default risk relates to the exposure of the claimant to the insolvency of the life office writing the structured settlement. This risk is zero for structured settlements because Policyholders Protection Act was amended to provide structured settlement annuitants with 100% protection in the event of insolvency. This is the only category of policy with this protection. It would be reasonable to anticipate that the regulatory regime for indemnity settlements would afford good default risk protection also.

Table 3: Defendant perspective

| Issue | Lump Sums | Structured Settlements | Indemnity |
|---|---|---|---|
| Once and for all settlement | + | + | -/+ |
| Cost of compensation | - | +/- | -/+ |
| Contributory negligence | + | - | - |
| On-going exposure to risk | + | +/- | - |

Once and for all settlement of liabilities is a significant advantage of both lump sums and structured settlements. Under an indemnity approach, the uncertainty over the future liability is significantly greater. This is an unappealing prospect for both insurers and insurance regulators. Over time, a market could conceivably develop to allow the buy-out of these liabilities.

Compared to the lump sum approach there may be savings to defendants as a result of applying structured settlements. These savings come via the tax treatment of structured settlements and the greater investment freedom permitted by pooling. In addition, structured settlements are based on a competitive market basis whereas a lump sum is assessed on a generally applicable basis that is likely to err on the side of conservatism. These savings are offset by the life office's margins for profit and contingencies and the currently restricted size of the market.

Whether or not there are savings under the indemnity basis is more difficult to establish. There will be greater administration costs, although these could be offset by savings from rehabilitation. There would also be a greater incentive to develop rehabilitation programmes. The trend towards the justification of more cautious assumptions in setting damages for an individual suggests that there could come a point when indemnity is actually more cost effective than paying lump sum or structured settlements.

The lump sum approach readily accommodates reductions in settlements for contributory negligence. This is potentially impossible under an indemnity regime unless for example care costs were to be made exempt and/or damages under other heads of could be used to fund the shortfall. Similar issues would apply in the event of a mandatory structured settlement approach.

Under the lump sum approach, the defendant transfers significant risk associated with the settlement to the claimant. This leaves the claimant in a position to experience both potential up-side or down-side as a result of the settlement. This result contradicts the principle of *restitutio in integrum* - the defendant is obliged to put the claimant back into the position he/she would have been in had the loss never occurred.

The Wells judgement is consistent with the principle that the appropriate basis of assessing risk for lump sum awards is at an individual as opposed to collective level. This supports the conclusion that lump sum settlements will increasingly be based on assumptions that are less favourable to defendants. This is because defendants will assess these risks at a collective level. This is the traditional approach to assessing damages by the Courts, but the Wells judgement is the first significant departure from this principle. In the long term, this will continue to be a cost issue for defendants to the extent that they are unable or unwilling to accept such risks on a collective basis.

## 4 Recent Developments in UK Personal Injury Compensation

### *Rehabilitation*

The UK has a relatively poor record on rehabilitation compared to other Western countries. For example, someone left paraplegic as a result of an accident has a 50% chance of returning to full-time employment in Scandinavia, 30% in the US and 15% in the UK. Following the report of the Rehabilitation Working Party in the 1999 IUA UK Bodily Injury Awards Study there has been a concerted effort to increase the profile of the issue. Post magazine have launched a Rehabilitation First Campaign under which insurers and legal firms are asked to sign up to a Best Practice Code of Conduct as set out in the IUA Report.

The benefits of rehabilitation are argued to be savings in claim costs by reducing injury severity and therefore damages. Companies with such programmes suggest savings in the range of 15% to 20% although this cannot be definitively quantified. Perceived claim management benefits are:

- Greater direct control over costs
- Improved understanding of cases and therefore better case estimation
- Development of good will for the insurance industry.

A key aspect of rehabilitation is early treatment. This is far more effective in minimising the scale of incapacity and overall cost than paying costs of care and commencing rehabilitation at a later stage when the claimant's chances of recovery are diminished.

In order to effect early treatment, increasing use is being made of case managers. Overseas studies suggest overall rehabilitation savings of 15 to 20% of relevant claim costs in Europe. In the USA a number of studies have suggested an average cost to benefit ratio of 1:2 with greater savings for younger people (as high as 1:8 for under 25s).

In practice, a case manager is appointed by mutual agreement between the claimant and the defendant. The defendant pays the case manager's fee. There are a number of specialist case management organisations in the UK. The objective of the case manager is to aid the claimant in managing special needs including rehabilitation as appropriate. It is in the insurers' interest to appoint case managers as quickly as possible, because they save costs by avoiding the build up of excessive care costs and aiding rehabilitation. Once a care regime has been instituted for an extended period, it is unlikely to be reduced by the judge even if it may be considered somewhat extravagant.

### *Woolf Reforms*

A description of the changes introduced by the Woolf reforms is included in last year's GISG Bodily Injury Paper. The effect of the changes appears to be:

- A reduction in the number of cases (mainly small) going to Court because of settlement out of Court, estimates of this reduction fall in the range of 20 to 35%.
- The fixed timescales specified by the reforms has led to changes in work practices and a speeding up of settlement for smaller cases.
- An increase in mediation and a generally less confrontational approach to settlement, this increased emphasis on mediation is more conducive to greater usage of structured settlements and the development of improved rehabilitation practices.
- In the cases that do go into litigation, there has been an increased cost because of the requirement for additional initial pre-trial work.

### *Lord Chancellor's Consultation*

In March 2000, the Lord Chancellor's Department issued a consultation paper entitled "Damages, The Discount Rate and Alternatives to Lump Sum Payments". The paper sought views on the rate of return that is appropriate for setting damages relating to future pecuniary losses and alternatives to lump sums.

The response of the Faculty and Institute of Actuaries is included in Appendix C. The response favours the introduction of court imposed non-reviewable structured settlements. The response acknowledges the limitations of such awards from the claimants' perspective, but notes that the introduction of reviewable awards requires consultation with the industry and its regulators. In short, significant further work is required for this to be a viable proposition.

### *The Wells judgement*

The Wells judgement relates to the discount rate used to determine the multipliers that are used in calculating lump sums. The judgement is also commonly referred to as "the Ogden judgement" because the multipliers are determined from the Ogden Tables. The principle underlying the discount rate is that the *individual* claimant should be exposed to minimum risk in the *basis* of calculation of the award. This is fair and reasonable in the opinion of the Lords reading the case. Hence the choice of a discount rate based on the investment yields perceived as minimum risk.

The rationale for this conclusion is that the *individual* claimant is not generally in the position to accept the risk inherent in the stock market because of the claimant requires "income, and a portion of their capital every year to meet their current cost of care." The text of the judgement emphasises that the actual choice of investment by the claimant is irrelevant to the basis of the calculation of the lump sum.

In Appendix B there are a number of extracts from the Wells judgement that highlight the rationale behind the judgement. We have also included comments about structured settlements. It is worth noting that although structured settlements were outside the scope of the case, Lord Steyn felt compelled to comment that Courts should be given the power to impose structured settlements in appropriate circumstances.

***The Ogden Tables***

The purpose of the tables is to facilitate the calculation of commuted values based upon published population mortality tables. This would provide a scientific basis for estimating an equitable lump sum that demonstrably matches a claimant's future income requirements.

Prior to the introduction of the Ogden Tables, judges used a system of multipliers that were driven by precedent and "rules of thumb". If a claimant or defendant wanted to apply multipliers based on population mortality, this would have to be introduced via expert witness testimony. The Civil Evidence Act 1995 makes the Ogden Tables admissible without the need for expert evidence.

***Longer-term trends***

The application of a risk-free discount rate establishes the principle that compensation should be based on a level of risk that is acceptable to an individual claimant. The rationale for this judgement stems from the assumption that the claimant is in a relatively weak position as an individual as opposed to a collective.

If this rationale is followed through, the basis of lump sum damages is likely to become increasingly conservative over time. If the system moves increasingly to a basis that compensation should be adequate in all reasonable circumstances, there will be an increased incentive for insurers to settle on a provisional basis and become more involved in rehabilitation.

The Wells judgement addresses the investment risks associated with damage assessment. The use of the Ogden tables under the Damages Act is intended to address mortality risk, but this is unsuitable for matching the needs an individual. The Working Party believes that structured settlements provide a frame-work for substantially removing the mortality and investment risks from claimants with long term needs. This will enable the insurance industry to accept these risks on a collective basis and result in overall cost savings.

## 5 International

We have focused on the United States, Australia, France, Germany, and Belgium. We have also considered only motor and workers' compensation insurance systems in those countries.

***USA***

In the US, structured settlements are being increasingly used, although traditionally motor accident victims have been compensated on a lump-sum basis. Workers compensation is a statutory insurance system that provides benefits including:

- wage loss: substantial but not complete wage replacement, which is typically paid in the form of periodic payments
- medical: full coverage of hospital costs and medical care
- rehabilitation: focused on an early return to work
- ancillary indemnity benefits include lump-sum compensation for lost digits, limbs, and in the worst eventuality, funeral costs.

Compensation for wage loss is generally on a 2/3 basis subject to minima and maxima based on State average wages. The income is tax-free in the hands of the recipient. Partial wage replacement is a designed to encourage an early return to work. These systems were introduced to replace tort-based systems. A stated level of benefits would be provided without regard to any possible contributory negligence, but the level of compensation for lost wages would not be as complete as might have been provided by the tort-system. The *quid pro quo* was that injured workers would no longer need to sue their employers for damages

Under workers compensation there is full coverage for medical and continuing care costs. This is often provided on a managed-care basis, in keeping with the way private medical insurance has evolved in the US. This allows the insurer to manage the type of treatment and choose the provider. Managed Care is currently a controversial topic in the U.S. and there have been accusations that managed-care health insurers are more concerned with making profits than the well being of their patients.

In general, this is a smaller issue in workers compensation because the insurer has an incentive to provide excellent care to facilitate early return to work. The rehabilitation system in US works fairly well due to its no-fault nature. The avoidance of conflict between the defendant and the claimant over fault issues means that rehabilitation efforts can begin as soon as possible. As mentioned previously, the chances of returning to full-time work for a paraplegic victim of a work accident are 30% in the US, but only 15% in the UK.

*Structured Settlements*

Structured settlements are now commonly used in both motor and workers compensation. They are usually based on the agreement of both parties and may be provided by means of either an annuity or a US Treasury Trust fund. The framework is very similar to the UK although the system in the UK is simpler.

Structured settlements have become increasingly common in the USA with about 50,000 per year being completed. Structured settlements were originally used for motor and other liability claims but are now increasingly being used for workers compensation.

The US system differs from the UK in that US structured settlements can be delivered by a trust fund that invests solely in US treasury bonds. This provides the recipient with tax-free interest income that is paid periodically in level payments over a period of up to 30 years. The principal is returned upon maturity to the claimant.

The primary incentive for the two parties to structure lies in the tax advantage. This is a win-win situation: the claimant can receive a greater annual income by structuring and the insurer can provide this at a lower cost. The insurer and the claimant usually notionally divide the savings. The only potential loser is the Treasury, due to loss of taxation revenue. This is nevertheless debatable because of savings in public welfare expenditure through the elimination of dissipation risk.

The other incentive lies in reducing the risk of dissipating the settlement. A study carried out in California showed that this risk was substantial. The survey suggested that 25% to 30% of accident victims dissipate lump sums within 2 months and 90% of claimants spend all of their lump sums within 5 years. [1]

Laws have recently been passed in a number of US jurisdictions that either prevent or limit the ability of those receiving structured settlements to sell them for cash to third parties. This is a restriction on the ability of claimants to dispose of windfall gains or dissipate structured settlements.

In some States, workers compensation structured settlements may be open to review if there is a change in condition or a mistake in fact. In other States, no review is allowed. The treatment of motor claims is also consistent with this basis.

[1] Source: California Practice Guide: Personal Injury, Rutter Group

***Australia (NSW)***

Comments on Australia relate to New South Wales. The compensation system resembles the traditional US systems before the wide use of structured settlements. Structured settlements are theoretically possible in Australia, but are rarely, if ever used. The main reasons are that:

- Structures are not tax-free as in the US or the UK.
- Structures are open to subsequent review. Unsurprisingly, this is unattractive to general insurers and makes them reluctant to structure.

As in the US, a study of lump sums in Australia has found that dissipation of lump sums is a significant feature. In a 1983 Study by C. Bass it was found that 75% of claimants exhausted their lump sums within 6 years. A study by Neave and Howell of the University of Adelaide in 1992 found that only 32% of claimants named "investment" as a major use of compensation in the first year, whereas 17% named a luxury item instead. Clearly, the size of the award and its materiality to the claimant is a significant issue to consider when interpreting such surveys.

In recent years, there has been lobbying for amendment to the tax rules to facilitate the greater use of structured settlement as a replacement for the traditional lump sum approach. In 1997 the NSW Motor Accident Authority (MAA) proposed the adoption of the UK Structured settlement framework. This was endorsed by the NSW government, but not adopted by the Federal Government because of the Treasury's concerns about loss of taxation revenue.

However, an independent study concluded that the Government would be more likely to make tax savings under a structured-settlement regime compared to lump sums.[2] The savings come from lower dissipation of awards and therefore lower reliance on the State Healthcare and the taxation revenue that would accrue in the event of a return to work.

In 1999 the Federal Government announced that the taxation issue would be considered in the 2000 budget. However, tax reform of structured settlements was not included in the 2000 budget. A recent study has suggested that the Australian Treasury would save between A$4-8 million per annum even if 30-60 structured settlements were done every year. This is equivalent to A$130,000 (£50,000) per structured settlement.

[2] Report on the taxation of Compensation Payments – PriceWaterhouseCoopers

***Continental Europe***

In most jurisdictions judges have the power to impose annuity settlements. In general, annuities for wage replacement are taxable. Payments in respect of other heads of damages are treated as non-taxable.

There is a general provision for motor damages to be paid by means of an annuity provided by the general insurer. The frequency of use and the features of the annuities vary by country. In some countries, lump sums are common although not perhaps for severely injured victims.

In France, indexed annuities are common with the government covering the cost of the indexation provision. However, the cost of the indexation falls on the general insurer for settlements arising from classes other than motor (for example medical malpractice). Judges can award indexed annuities. The basis of indexation is not standard and can be set by the judge as deemed appropriate.

In Belgium, lump sums predominate. When annuities are issued, they are indexed and the insurer bears the cost of indexation. The use of these annuities is rare and mainly relates to severely injured minors.

In Germany, annuities are used on an unindexed basis - this presumably was not problematic due to the historically low levels of German inflation. In Germany, lump sums are now in common use.

With regard to taxation of these annuities in continental Europe, there is a distinction between wage replacement heads of damage and other heads. In general, annuities for wage replacement are deemed to be taxable whereas annuities provided for other heads of damage (such as nursing care) are not.

*Workers Compensation systems*

Belgium and Portugal have workers' compensation insurance systems that are similar to the US and Australia. In Belgium the statutory workers compensation system provides for wage replacement on a capped basis by means of an indexed annuity. The cap is fairly low at 1 million Belgian Francs (around £16,000). Workers have the option to purchase additional wage replacement cover, but this is generally only available on an unindexed basis.

The medical benefits under workers' compensation are slightly different to those in the US. The regular medical system in Belgium is operated on a coinsurance basis, with patients paying a proportion of the cost for each treatment. In the case of an injured worker, the workers' compensation insurer covers the patient’s coinsurance payments.

## 6 Ways Forward for Compensation in the UK

Possible alternative approaches to compensation are as follows. These comments are in relation to large cases involving long-term disability where we believe that lump sums are generally inappropriate.

### *Indemnity Settlements*

Under an indemnity settlement, the defendant indemnifies the claimant against the costs of his future needs arising from the injury suffered. The indemnity is both in respect of quantum and timing. Indemnity settlements are considered impractical at present. The main reasons are as follows:

- The defendant's liability is significantly more variable. This would increase the uncertainty affecting the defendant's financial position and has implications for insurance regulators.
- The physical consequences of the injury suffered may change over time. This suggests that any system based on indemnity would require regular reviews of individual cases. This could prove awkward for both defendants and claimants and result in continuing disputes.
- The costs of administering an indemnity settlement would be much higher than a lump-sum settlement. This approach is clearly unsuitable for modest settlements.
- There are regulation, cost and implementation implications that would have to be overcome.

A radical approach to the problem of indemnity settlements for catastrophic injuries would be to establish a pool for accepting these risks on a managed care basis. The pool could be funded by levies and run either privately by insurers or by the State. This is not too dissimilar to the concept of MIB levies for uninsured losses.

A side effect of such an approach for motor insurance is that insurers of the highest-risk drivers would be likely to be subsidised by insurers of the rest of the driving population. This is because the levy structure would be unlikely to match the risk exposure of individual insurers accurately.

### *Structured Settlements*

Structured settlements allow the claimant to transfer mortality investment and limited inflation risk to the office writing the structured settlement. It should be recognised that fixed structured settlements do not provide an indemnity.

At the Institute of Actuaries, Damages Seminar in March 2000, reviewable structured settlements were considered as a means of getting closer to indemnities. However, this option is likely to prove unattractive to both insurers and claimants because of the uncertainty that it introduces on both sides. In addition any system of review would need to be seen to be fair and equitable and is likely to prove complex to administer effectively.

Under certain circumstances, provisional lump sum settlements have been made where the prognosis for a given injury is particularly uncertain. The same principles could be applied to structured settlements for those cases.

We see fixed structured settlements as a practical way forward in the medium term. We agree with Lord Steyn that parliament should give Courts the power to impose structured settlements in appropriate circumstances. Over time, this approach will probably develop to become closer to an indemnity system, particularly in relation to care costs. This appears to be the natural evolution of the system. Rehabilitation will become increasingly important over time.

In summary, the key feature of the structured settlement approach is that the risks in terms of both longevity and inflation (in RPI terms) are transferred from the defendant to a life office and not to the claimant as under the lump sum approach. To this extent, structured settlements represent a significant step forward in the settlement of personal injury cases, especially large cases involving loss over a prolonged period. In Appendix E, we have summarised the views of a defendant claim practitioner on lump sums compared to structured settlements.

***Rehabilitation***

The advantages of early rehabilitation are a potential reduction in overall liability because the claimant's losses are potentially reduced. From the claimant's perspective, there are potential abuses if insurers provide medical assistance as a means to gather medical information about the claimant that would otherwise be unavailable. In more severe injury cases, the claimant's quality of life is usually significantly improved.

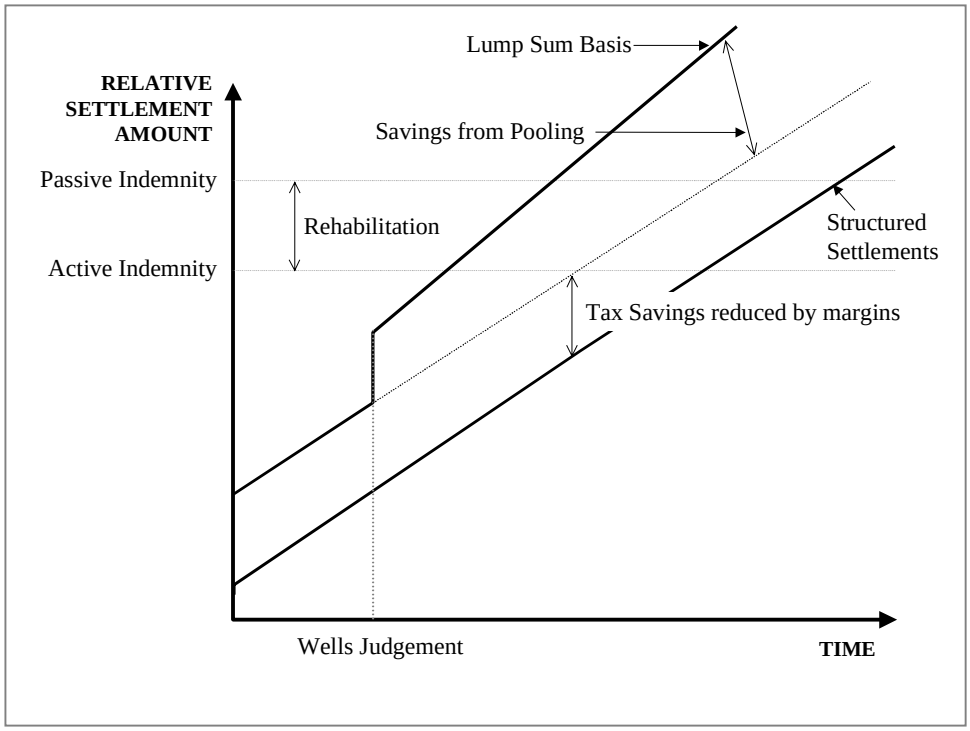
The rehabilitation approach is particularly suitable for motor claims. For the majority of these cases, liability is not in doubt and the litigation is usually about quantum. For the worst cases, rehabilitation is already widely undertaken at an early stage, but there is scope for both continuing the effort beyond the acute stage[3] and also extending the scope of rehabilitation toward less severe injuries.

[3] Rehabilitation experts often argue that the UK has acute care that is amongst the best in the world but is let down by difficulties over funding for care beyond the first few weeks.

***Future Developments***

The following graph shows a perspective of the relative costs of structured settlements and lump sum settlements. This is in the context of alternative indemnity approaches to claim settlement. The passive approach involves minimum rehabilitation and the active involves efforts to rehabilitate. Clearly the significant movements are more likely to come in step changes instead of the smooth lines as shown by the graph.

Conceptual Framework




We believe that lump sum settlement on current bases is likely to fall below actual costs of indemnification. This is because current multipliers take account of inflation of damages in line with RPI. Inflation of earnings and the cost of care has historically risen at rates significantly in excess of RPI. This means that we can expect to see continuing real increases in liability awards as the Courts become more sophisticated in the assessment of damages.

In the future, lump sum awards may rise to exceed the cost of indemnification because of the assessment of risk on bases appropriate to individual exposure to risk instead of collective pooled risk. The Wells judgement is consistent with this principle.

The absolute cost of structured settlements at any time will vary significantly with interest rates. However, the underlying cost is likely to fall below the lump-sum

approach. This is because of tax and pooling savings. Pooling savings as compared to the lump sum approach are expected to increase over time.

The cost of structured settlements could in time exceed indemnity costs because the income from a structured settlement continues to be paid even if the claimant recovers. Defendants are only likely to move toward an indemnity (in conjunction with rehabilitation) approach to settlement when indemnity becomes more cost effective than the alternatives of lump sum or fixed structured settlements.

We also believe that structured settlements have a significant role to play in reducing the risk that claimants will dissipate lump sums and come to rely on the State. This will therefore reduce costs to the State and provides support for the tax advantages attaching to structured settlements.

## Appendix A

### *Assessment of Damages in Liability Claims*

These losses relate to future loss of savings and earnings capacity and additional future costs resulting from negligent act. The main types of damages follow below.

*General Damages*

General damages flow from the liability of the defendant and it is not necessary for the plaintiff to prove his loss. They consist of losses for pain and suffering and loss of amenity in the general sense.

There are a number of heads of damages and attempts are made continuously to develop new heads of damage. Extending heads of damage is thought to be a prime contributor to recent inflation in injury awards.

*Special Damages – incurred to date.*

These are amounts in respect of losses and expenses incurred up to the date of the trial. These are capable of proof (i.e. receipts could be produced). The most important head of damage in this category will often be past loss of earnings or profits.

*Special Damages – Future losses*

The main heads of damages here would be loss of future income and the cost of care.

*Exemplary or Punitive Damages*

These are awarded in addition to compensatory damages to express the court's view that the defendant's conduct is deplorable or outrageous. Very large sums awarded for such damages in the USA often attract publicity in the UK.

In England and Wales, punitive damages can only be awarded in a limited number of defined situations, and are very unlikely in a personal injury cases.

### *Calculating claim amounts for Personal Injury claims*

As outlined above, several heads of claim exist for personal injury claims. Most relate to costs incurred between accident date and settlement date, but some relate to costs to be incurred in the future, or lost earnings in the past or the future.

The typical approach to calculation of an award in respect of future cost of care or loss of earnings is to multiply a multiplicand, the annual amount necessary to provide care or the annual loss of income, by a multiplier.

The multiplier represents the expected future number of years the plaintiff will live and includes a discount for investment income. In the case of loss of income, there is also a further discount for the risk of becoming unemployed or disabled. Different multipliers will be applied under different heads of damage. Effectively these are annuity factors as recognised from life insurance. However, judges often selected multipliers using "rules of thumb" built up over the years rather than actuarial methods.

Until the Civil Evidence Act (1995) was enacted, mortality tables were not "admissible evidence" but needed to be supported by an expert witness (i.e. actuary) on each occasion.

Where tables were used before the Wells judgement, the interest rate assumed in the multipliers was typically in the range 4 to 5% net of tax, based loosely upon a 6% per annum gross return. This was intended to include an allowance for future inflation of the multiplicand.

## APPENDIX B

## EXTRACTS FROM THE WELLS JUDGEMENT

The Wells judgement is dated 16 July 1998 and relates to:

Page versus Sheerness Steel Company Ltd.
Wells versus Wells
Thomas versus Brighton Health Authority

***Summary***

The judgement is confined to the basis of assessing damages. The Lords came to the view that the principle of minimum risk investment for claimants is the most appropriate.

The arguments are summarised by the following text:

*Lord Lloyd of Berwick*

"How the plaintiffs will in fact invest their damages is, of course, irrelevant. That is a question for them. It cannot affect the calculation."

"The inability of the experts to reach agreement on the figures is not, in the end, of great consequence. [Agreement on past investment performance figures.] For the problem with equities lies elsewhere. Granted that a substantial proportion of equities is the best long-term investment for the ordinary prudent investor, the question is whether the same is true for these plaintiffs. The ordinary investor may be presumed to have enough to live on. He can meet his day-to-day requirements. If the equity market suffers a catastrophic fall, as it did in 1972, he has no immediate need to sell. He can abide his time, and wait until the equity market eventually recovers."

"The plaintiffs are not in the same happy position. They are not 'ordinary investors' in the sense that they can wait for long-term recovery, remembering that it was not until 1989 that equity prices regained their old pre-1972 level in real terms. For they need the income, and a portion of their capital every year to meet their current cost of care. A plaintiff who invested the whole of his award in equities in 1972 would have found that their real value had fallen by 41% in 1973 and by a further 62% in 1974. The real value of the income on his equities had also fallen."

"So it does not follow that a prudent investment for the ordinary investor is a prudent investment for the plaintiffs. Equities may well prove the best long-term investment. But their volatility over the short term creates a serious risk."

General comments about the assessment of lump sum awards*:*

"It is of the nature of a lump sum payment that it may, in respect of future pecuniary loss, prove to be either too little or too much. So far as the multiplier is concerned, the plaintiff may die the next day, or live beyond his normal expectation of life. So far as the multiplicand is concerned, the cost of care may exceed everyone's best estimate. Or a new cure or less expensive form of treatment may be discovered. But these uncertainties do not accept the basic principle. The purpose of the award is to put the plaintiff in the same position, financially, as if he had not been injured. The sum should be calculated as accurately as possible, making just allowance, where this is appropriate, for contingencies. But once the calculation is done, there is no justification for imposing an artificial cap on the multiplier. There is no room for a judicial scaling down. Current awards in the most serious cases may seem high. The present appeals may be taken as examples. But there is no more reason to reduce the awards, if properly calculated, because they seem high than there is to increase the awards because the awards because the injuries are very severe."

*Lord Hope of Craighead*

"It has often been said that the assessment of damages is not an exact science – that all the law can do is work out as best it can, in a rough and ready way, the sum to be paid to the plaintiff as compensation for the loss and injury. There remains much truth in these statements, despite the important advances which have been made in the search for greater accuracy. The amount of the award to be made for pain, suffering and loss of amenity can not be precisely calculated. All that can be done is to award such sum, within the broad criterion of what is reasonable and in line with similar awards in comparable cases, as represents the court's best estimate of the plaintiff's assessment of past loss of wages and of other past losses and expenses which fall under the broad heading of special damages be matched when it comes to proceed by means of assumptions. The calculations which it then it makes will involve the use of arithmetic as the multiplier is applied to the multiplicand. To that extent the exercise will give the impression of accuracy. But the accuracy of the result achieved by arithmetic will depend on the assumptions on which it has been based. In making these assumptions the court must do the best it can on the available evidence."

***Structured Settlements***

Structured Settlements were outside the remit of the case but Lord Steyn comments:

"Leaving to one side of the policy arguments for and against the 100% principle [100% compensation for loss of earnings. It is argued that a lower level of compensation is required to provide an incentive for return to work[4]], there is a major structural flaw in the present system. It is the inflexibility of the lump sum system which requires an assessment of damages once and for all of future pecuniary losses. In the case of the great majority of relatively minor injuries the plaintiff will have recovered before his damages are assessed and the lump sum system works satisfactorily. But the lump sum system causes acute problems in cases of serious injuries with consequences enduring after the assessment of damages. In such cases the judge must often resort to guesswork about the future. Inevitably, judges will strain to ensure that a seriously injured plaintiff is properly cared for whatever the future may have in store for him. It is a wasteful system since the courts are sometimes compelled to award large sums that turn out not to be needed. It is true, of course, that there is statutory provision for periodic payments: see section 2 of the Damages Act 1996. But the court only has this power if both parties agree. Such agreement is never, or virtually never, forthcoming. The present power to order periodic payments is a dead letter. The solution is relatively straightforward. The court ought to be given the power of its own motion to make an award for periodic payments rather than a lump sum in appropriate cases. Such power is perfectly consistent with the principle of full compensation for pecuniary loss. Except perhaps for the distaste of personal injury lawyers for change to a familiar system, I can think of no substantial argument to the contrary. But the judges cannot make the change, only Parliament can solve the problem."

[4] It could be argued that the current system implicitly allows for less than 100% compensation for loss of earnings because the indexation applied to future savings is consistent with RPI

**APPENDIX C**

# THE LORD CHANCELLOR'S DEPARTMENT

# CONSULTATION PAPER ON DAMAGES

## *The discount rate and alternatives to lump sum payments*

## JOINT RESPONSE BY THE FACULTY AND INSTITUTE OF ACTUARIES

## AND THE ASSOCIATION OF CONSULTING ACTUARIES

**16 May 2000**

## Introduction

We welcome the issue of the Consultation Paper and the opportunity to respond to it. Members of our profession are involved in the personal injury field in many ways. Actuaries employed by general insurers and Lloyds syndicates are concerned with setting appropriate premium rates and prudent reserves for contracts involving personal injury risk. Actuaries employed by life insurance companies are involved in the design, pricing and subsequent management of structured settlement annuities including assessments of the mortality risks of injured claimants as well as risks associated with the need for appropriate investments to match the periodic payments. Actuaries are also involved in advising claimants and defendants on the identification and management of various financial risks implicit in personal injury settlements, and in the production of reports for the courts.

Personal injury settlements require the crystallisation of various future risks in the interests of effecting a 'clean-break' settlement or allocating future uncertainty in a reasonable and practical way between the claimant and defendant. The actuarial profession is uniquely positioned to contribute to this debate and to offer a view that considers not only the interests of defendants or claimants, but also of other parties whom may directly or indirectly be involved.

## General comments and summary

**1** The aim of any method of compensating for personal injury should be to provide fair compensation and, where possible, to avoid the claimant having to take financial and other (eg mortality) risks which he would not have had to take had it not been for the accident. In practice the issues to consider are:

- How closely is it desired that the theoretical principle of indemnity should be followed in practice? This raises issues about which party carries the future inflation, investment, mortality, healthcare and other risks and whether periodic losses should be compensated by periodic payments or lump sums.
- Compensation by periodic payments raises further issues concerned with the definition of the award, whether in terms of a package of benefits (which is outside the scope of the present consultation) or pre-defined monetary amounts linked to suitable indices of inflation, with or without reviewability.
- The legislative and public policy changes necessary to put into effect the desired solution and the willingness of appropriate parties to take the necessary action.
- The willingness of defendants to undertake more risks than they have become accustomed to under the present system, or to provide additional services (for example, manage the healthcare themselves with

scope for innovative procedures to reduce costs).

We refer to many of these in our response to the individual questions.

**2** ***If the present system of compensation by lump-sum awards is to be retained, then the real issue underlying the choice of discount rate is the level of risk considered appropriate for the claimant to take.***

This should be considered in conjunction with the practical application of the principle of indemnity. The House of Lords addressed this issue in Wells v Wells and clarified that individual claimants should not have to take the risks of investing in equities. We have responded to the first part of the consultation paper on this basis. Any change to this principle is a matter of public policy and if the Government concludes that a claimant should be required to take some investment risk (either on the whole award or on certain components of it) then we believe the actuarial profession is uniquely placed to assist in the understanding of the risk and translating the prescribed level of risk into the corresponding investment policy for the purposes of calculating the appropriate discount rate.

Instead of a prescribed discount rate which will not change as often as changes in the investment markets dictate, we recommend a formula-based approach with the Government Actuary publishing the discount rate suggested by the formula on a monthly or quarterly basis. We feel that taxation should be allowed for separately and some general guidance based on the size of the award could easily be produced.

The lump sum settlement, even with the discount rate based on index linked gilts, does not remove risk entirely from the claimant. Three major risks which will still remain with the claimant are:

- earnings will continue to grow at a faster rate in future than RPI;
- that cost of care will continue to outpace the RPI; and
- that the significant mortality improvements observed in recent years, not just for the general population but also through improved drug and other treatments for severely impaired people too, will continue in future.[5]

It could be argued that this is not consistent with the principle of indemnity since, had it not been for the accident, the claimant would not have had to take any of these risks.

**3** ***We favour the introduction of court imposed, non-reviewable periodic***

[5] There is a significant additional mortality risk faced by claimants because of variations in the longevity of individuals as opposed to the average. This risk is analysed in Appendix D.

***payment awards.***

We consider that, rather than concentrating on the possible benefits of long-term success from the investment of a large lump sum award, it would be more appropriate to address the consequences for society more generally of claimants exhausting lump sum awards due to fraud, mismanagement or simple misfortune as a result of pursuing (or having to pursue) a non-risk-free investment strategy. To the extent that periodic payments awards mitigate some of these concerns, they would appear to convey a wider benefit to society.

The Faculty and Institute of Actuaries published a discussion paper in December 1997 which recommended periodic income or benefits awards. The actuarial profession has since held two seminars on this subject. At the most recent of these, held at the Institute of Actuaries on 15 March 2000, the motion debated was "The needs of victims and society would be better served by courts having the power to make income or benefit awards. This would be more effective than awarding lump sums". The seminar was attended by over 100 people including many eminent lawyers and the motion was carried almost unanimously.

Periodic payment awards are a better way of satisfying the principle of indemnity in practice. They avoid the need for the courts to determine a discount rate and reduce the inevitable over or under compensation arising from a lump sum award.

We note that bottom-up structured settlements, a form of income based awards, already exist. They avoid the need for lump sum awards and offer the scope for a more efficient form of settlement. In particular, they remove the mortality risk entirely from the claimant. However, they are not used much in practice because they require the agreement of both parties. We believe the courts should be given the power to order non-reviewable income based structured settlements, subject to any legislative changes needed to make it easier for general insurers to undertake such liabilities.

Income settlements, where the award is defined in monetary terms and linked to the RPI, will however do nothing to protect the claimant from the risk that the major components of his/her award (namely earnings loss and cost of care) will experience higher rates of inflation than the RPI. There is a strong argument for the relevant components of income awards to be expressed in terms of earnings inflation (or higher); however it should be recognised that present legislation does not permit such awards to be secured through matching life insurance policies.

**4** ***We believe that the success of reviewable income-based awards will depend***

***on the correct regulatory environment for life and general insurers and the willingness of defendants to be innovative and to undertake new forms of risk.***

We suggest that reviewable awards should not be introduced in haste, without detailed consultation with the general insurance industry and insurance company regulators.

Benefits based awards are perhaps a better alternative to reviewable periodic payments but these are outside the scope of the present consultation, and in any case, much work remains to be done in this area before they can become a viable proposition.

**Q1 Do consultees agree that the power under section 1 of the Damages Act 1996 should be exercised?**

Yes. This should generally avoid the need for courts to consider the appropriate rate and provide the certainty which insurers need to set appropriate premium rates.

**Q2 Do consultees agree that the Lord Chancellor can prescribe a discount rate that is not based on the assumption that claimants will invest in ILGS and, if yes, on what basis should the rate be set?**

Whether the Lord Chancellor has the power to do this under existing legislation is a matter of law. As stated above, we believe the real issue concerns the degree of risk which it is considered appropriate for the claimant to take; we believe that to be a matter of public policy which should be initiated by the Government. The arguments for and against investment in equities for injured claimants have been well documented in the evidence put before the House of Lords at the time of the Wells judgement in 1998. If, as a matter of public policy the decision then reached by the House of Lords is reversed and it is decided that claimants should be required to take some investment risk, then equity returns would be relevant in determining the discount rate.

**Q3 If consultees favour a discount rate based wholly or partly on the rate of return from equities, what indicator should be used to assess that return?**

Not applicable – see 2. of summary above.

**Q4 If consultees favour a discount rate based on the average return from ILGS and equities, how should the average be calculated?**

Not applicable – see 2. of summary above.

**Q5 If the power is exercised, should it prescribe a fixed rate or should it prescribe a formula by which the parties and the courts can calculate the applicable rate in the particular case? What strengths and drawbacks to these two approaches do consultees see?**

We believe that the power should prescribe a formula rather than a fixed rate. Using the ILGS approach, 3% may have been appropriate at the time of the Wells v Wells judgement but is no longer valid because of subsequent changes in the investment markets. Damages need to be invested at the time that they are awarded and a fixed rate is unlikely to change rapidly enough,

as the purpose of the present consultation clearly demonstrates. Consequently, the award will buy different amounts of income depending on market conditions at the time of investment – in other words, the claimant will purchase more or less than the annual loss which the court intended to compensate him/her for.

**Q6 Do consultees favour fixing the rate by averaging the relevant indicator over a period, and if so, what period do they recommend and why? If not, how else might the rate be fixed?**

Theoretically the annualised rate applicable on the date of investment of the award is appropriate. However, we accept that this is not practical and suggest that a figure determined by an agreed formula is published at the beginning of each month by the Government Actuary, which would apply to all settlements made during that month. If it is considered that a longer period would be more practical, then a three month period could be used. Advantages of this method are that certain technical adjustments which are appropriate to the yields published in the FT could easily be accommodated (see footnote to table in Q12), and the recommended rate would be easily accessible through various sources (websites, legal journals, etc).

**Q7 Do consultees agree that the rate, if set, should be accurate to the nearest half a per cent?**

As explained in Q5, the correct rate is the rate at which the award can be invested. Rounding (and averaging as well) will introduce anomalies and hence opportunities for arbitrage, but we appreciate that for practical reasons some rounding is unavoidable. We suggest that the annualised rate should be rounded to the nearest quarter per cent. Using half a per cent could lead to a relatively large difference in multipliers, and hence awards. For example, a change of a quarter per cent in the discount rate is broadly equivalent to a change of 6% in the lump sum for a lifetime loss for a ten year old claimant (less for older claimants). The Ogden Tables can continue to be tabulated in half per cent steps with multipliers at intermediate rates being obtained by interpolation.

**Q8 If the power is to be exercised, what arrangements should there be for the discount rate to be reviewed, and at what intervals?**

If the formula approach is adopted then the need for any review of methodology should be infrequent. Index-linked gilts rarely change dramatically from one month to another and, in any case, it is impossible to predict the direction in which they will change, so we believe the objections to a formula set out in paragraphs 26 and 27 are not relevant if the approach suggested in Q6 is adopted.

**Q9 What views do consultees have on the issue of different rates for different classes of case, and where consultees favour different rates according to the length of the award, where should the dividing line be drawn?**

If the ILGS approach is adopted generally then there is no need to use different rates for awards of different durations since the real yields on ILGS do not vary much by term (at least for the range of stocks suitable for most claimants).

If, as a matter of public policy, it was decided that the ILGS approach should be adopted for costs of care but a strategy based partly or wholly on equities should be used to determine an award for future loss of earnings, it might be appropriate to use different discount rates for different heads of claim. Different rates might also be appropriate to allow for differing future inflation rates applicable to different heads of claim, eg. allowing for earnings to increase at a rate higher than RPI (the evidence suggests 1% to 2% higher), or for the cost of care to rise at an even faster rate.

If the prescribed discount rate is intended to be net of taxation then there is an argument for differentiation by size of claim; however we believe the prescribed discount rate should be gross, with taxation allowed for separately (see Q11).

**Q10 Do consultees believe that there is a problem with retrospection and, if so, what form should transitional provisions take when the rate changes?**

Retrospection may be considered unfair by general insurers who may have previously charged insurance premiums (especially for policies issued prior to the House of Lords judgement in 1998) on the assumption that the method of calculating compensation at the time of issuing the policies would have continued.

**Q11 How do consultees think that taxation should be taken into account?**

Because the tax rates on the income from an award vary from nil in cases where the income is less than the personal allowance to an average rate of 30% or more in the largest cases we recommend that a gross rate is prescribed and tax is allowed for as appropriate in each case. It would be possible to prepare general guidelines as to the appropriate allowance for different amounts of future awards.

**Q12 Bearing all these issues in mind, what rate would consultees now set?**

Using the formula based ILGS approach (see Q5-Q8), the current gross rate (calculated at the end of April 2000 for all settlements in May 2000) rounded to the nearest quarter per cent would be 2.0 per cent. The gross rates since May 1998 on the same basis would have been:

| ***Settlement date*** | ***Discount rate (gross) % (ILGS Index over 5 yrs, 5% inflation)*** |
|---|---|
| ***1998*** | |
| May | 2.75 |
| June | 2.75 |
| July | 2.75 |
| August | 2.50 |
| September | 2.50 |
| October | 2.50 |
| November | 2.50 |
| December | 2.25 |
| ***1999*** | |
| January | 2.00 |
| February | 2.00 |
| March | 2.00 |
| April | 1.75 |
| May | 1.75 |
| June | 1.75 |
| July | 2.00 |
| August | 2.00 |
| September | 2.25 |
| October | 2.25 |
| November | 2.00 |
| December | 1.75 |
| ***2000*** | |
| January | 1.75 |
| February | 2.00 |
| March | 2.00 |
| April | 2.00 |
| May | 2.00 |

*These are the annualised yields on the last working day in the previous month.*

*The income from ILGS is calculated by reference to the RPI index 8 months previously. The calculation of the real yield therefore requires an assumption regarding inflation in the intervening period. The above table*

*has been calculated using a published index which uses 5% for this purpose but it could be argued that a more appropriate assumption would be the actual inflation at the time of calculating the yield. A technical adjustment could easily be accommodated in the formula driven approach suggested in Q5.*

**Q13 Should courts be given powers to impose structured settlements, even when both parties do not consent?**

Top down structured settlements are merely another investment option for the claimant, subject to the agreement of the defendant, because a lump sum settlement needs to be agreed (or imposed by the court) first. As such, the inefficiency of the lump sum system is carried through into the top down structured settlement – the lump sum favours one or the other party and by applying it towards a structured settlement will either accentuate this advantage or redress some of the balance. The outcome will still be inequitable.

Bottom up structured settlements are much better because they avoid the need to go through the lump sum settlement method and therefore avoid its inadequacies. They enable the mortality and investment risks to stay with the defendant and be dealt with in a more flexible manner. For example, the defendant could reinsure the mortality risk but retain the investment risk, with the advantage that they could then take a long-term view and invest in equities or similar investments to reduce the cost (short-term volatility is not so much a problem for defendants as it is for individual claimants because, by their nature, they have a greater capacity to absorb risks). We believe the courts should be given the power to order bottom up structured settlements and that they should be encouraged to use this as the primary method of settlement. We do not believe that claimants and defendants should be the ultimate decision makers on this matter (as at present), otherwise there is no logical basis for mutual agreement since the lump sum settlement will always be advantageous to one of the parties.

**Q14 Should the courts have power to order non-reviewable periodic payments (other than structured settlements), even when both parties do not consent?**

We are not sure what the distinction between this type of an arrangement and a bottom-up structured settlement would be. If the suggestion is to eliminate some of the unnecessary bureaucracy associated with structured settlements (for example, an easier form of agreement and not having to get insurance quotations for 'comfort' even when it is clear that an insurance approach is not envisaged by the defendant), then we would be in favour, subject to satisfaction that there are no legal impediments to what is being proposed

(for example, a conflicting regulatory regime for general insurers).

**Q15 Should the courts have power to order reviewable periodic payments? If so, should such orders require the consent of both parties?**

In theory reviewable periodic payments should provide a better match to the principle of indemnity since some of the future uncertainty (for example, the claimant's medical condition or the future care regime) does not have to be crystallised at the time of settlement. A further advantage would be that claims could be settled more quickly since it would not be necessary to wait until the claimant's medical condition had stabilised sufficiently. However, reviewable periodic payments would require defendants to take a much more open-ended liability. Whether the current constitution of general insurance companies and their regulatory requirements permit this is a matter for further investigation. Also of vital importance is the willingness of defendants to take on such additional risks. We would suggest that this matter should be pursued separately with practitioners in the general insurance field and insurance company regulators.

Benefits awards are an alternative to reviewable periodic awards defined in monetary terms. We have not commented on these because they appear to be outside the scope of the present consultation.

**Q16 Should the possibility of lump sum awards be retained, for some or all heads of damage? If so, for which heads of damage would lump sum awards and periodic payments be applicable?**

It is clear that the courts should retain the power to make lump sum awards. These remain appropriate for pain and suffering, past losses and smaller awards as well as items of future loss which are not capable of compensation by income, eg compensation for 'lost' years where the claimant's life expectation has been reduced. Periodic payments are likely to be appropriate in relation to future loss of earnings and costs of care.

**Q17 What comments do consultees wish to make about tax and inflation provisions which periodic payments might attract?**

Periodic payments should be free of tax as for structured settlements. Ideally they should match the inflation of the corresponding head of damage which for both loss of earnings and costs of care is likely to be in excess of RPI – see Q11.

**Q18 If periodic payments are to be available, how should the courts be satisfied as to the defendant's financial means, and the security of the payments in the future?**

Large organisations which can demonstrate the necessary financial security (eg the NHS, MOD, and general insurance companies) could be allowed to self-fund periodic payments. Others should be required to purchase annuities from a UK life assurance company subject to 100% protection under the Policyholders Protection Act, or an EEA insurer. For Lloyds syndicates, actuarial certification of reserves could be a way of providing comfort on their financial security.

For reviewable awards, it is unlikely that security could be provided through the insurance route unless the insurance industry is prepared to undertake the open ended liability and the regulatory regime is changed (the present regulatory regime does not enable life insurance companies to issue policies that match inflation risks other than RPI). Self-funded periodic payments are the only practical alternative in such cases and the security of the settlement would be synonymous with the financial security of the defendant. Actuarial certification of the reserves held by the defendants to meet their liabilities would provide a level of comfort but not absolute security.

**Q19 Should periodic payments be restricted to personal injury and death claims? If not, in which other types of claims should they be available?**

Periodic payment awards should be made in all cases where the loss is manifested in terms of future monetary costs or losses of a periodic nature.

**Q20 What other issues do respondents believe should be taken into account in reaching a conclusion on these questions?**

See General Comments at the beginning of this paper.

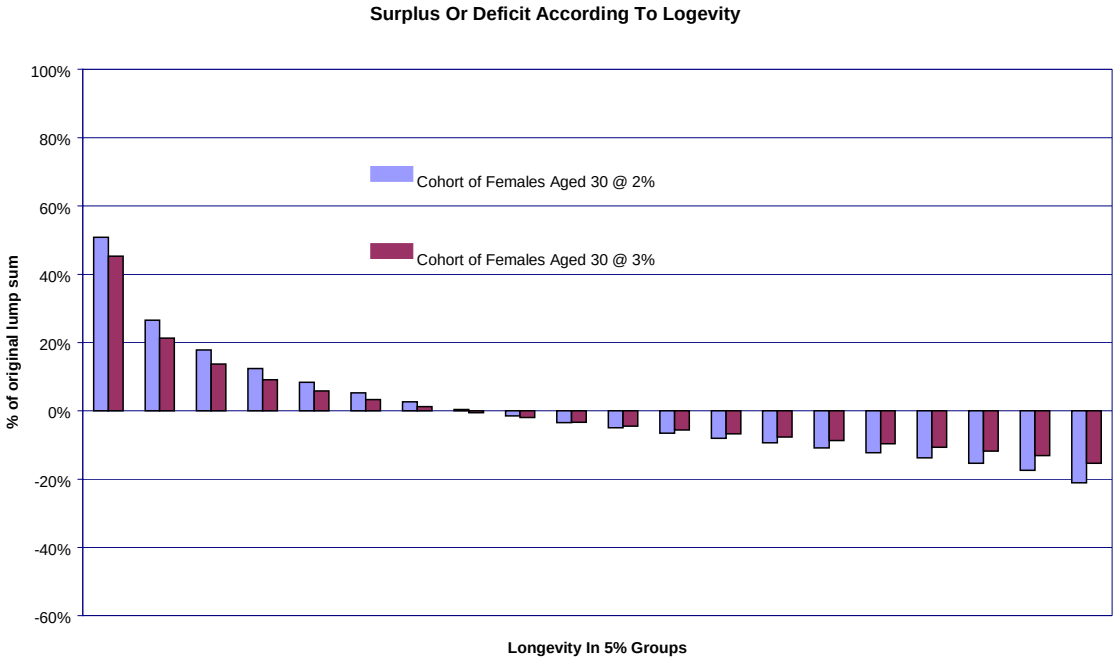
**APPENDIX D**

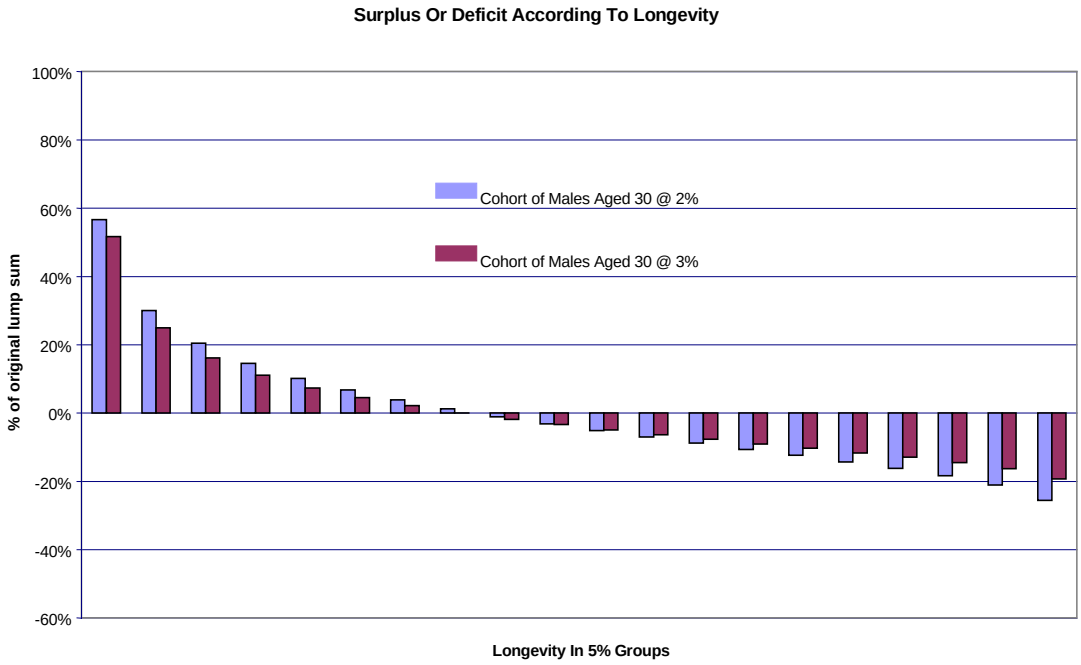
## MORTALITY RISK: ADEQUACY OF LUMPSUMS FOR INDIVIDUALS

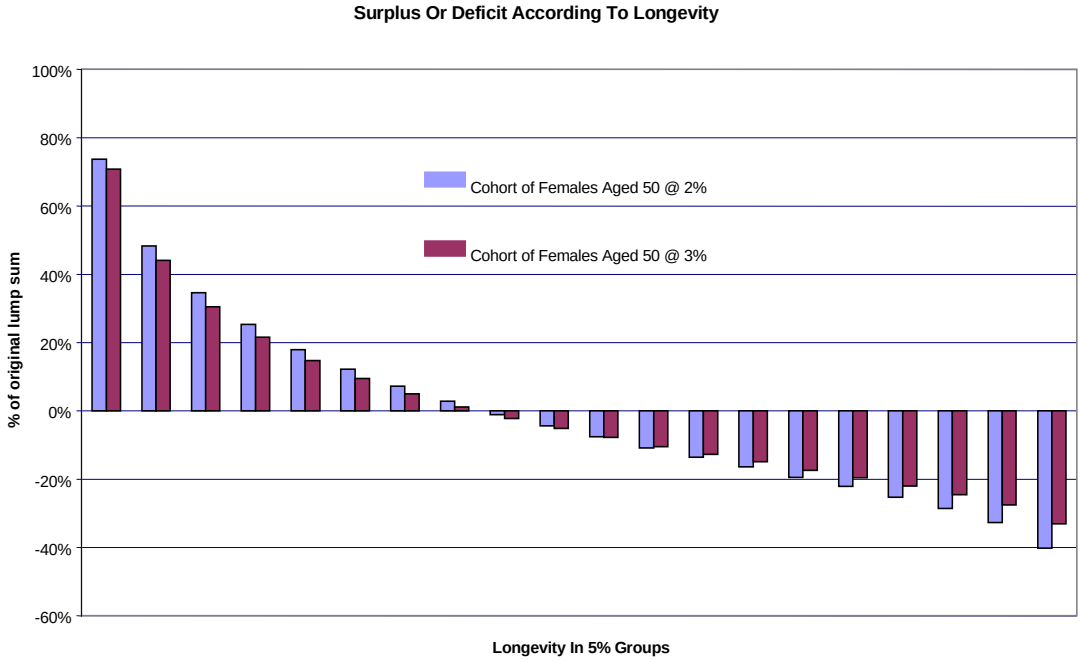
The purpose of this analysis is to demonstrate the impact of the structural error inherent within lump sum settlements relating to mortality risk. No allowance is made for error due to incorrect application of the tables or the forecasting error in the tables. We applied the mortality tables to cohorts of individuals and compared the present value of the payments they will actually require to the lump sum annuity factors implied by the Ogden Tables.

Tables ELT15 for both males and females were used to compare lump sums to actual needs of individuals. This is the mortality basis underlying the current published Ogden tables. We have calculated lump sums for males and females aged 30 and 50, based on interest rates of 2% and 3%. The effect for other similar interest rates can be calculated approximately by linear interpolation of the difference between the results for 2% and 3%.

The results are summarised in the following graphs and tables. The data summarises the deficit or surplus resulting from a comparison of lump sums to the future needs of individuals in 5% groups according to expected longevity.




Surplus Or Deficit According To Longevity
100%
80%
60%
40%
20%
0%
-20%
-40%
-60%
% of original lump sum
Cohort of Males Aged 30 @ 2%
Cohort of Males Aged 30 @ 3%
Longevity In 5% Groups


Surplus Or Deficit According To Longevity
100%
80%
60%
40%
20%
0%
-20%
-40%
-60%
% of original lump sum
Cohort of Females Aged 50 @ 2%
Cohort of Females Aged 50 @ 3%
Longevity In 5% Groups

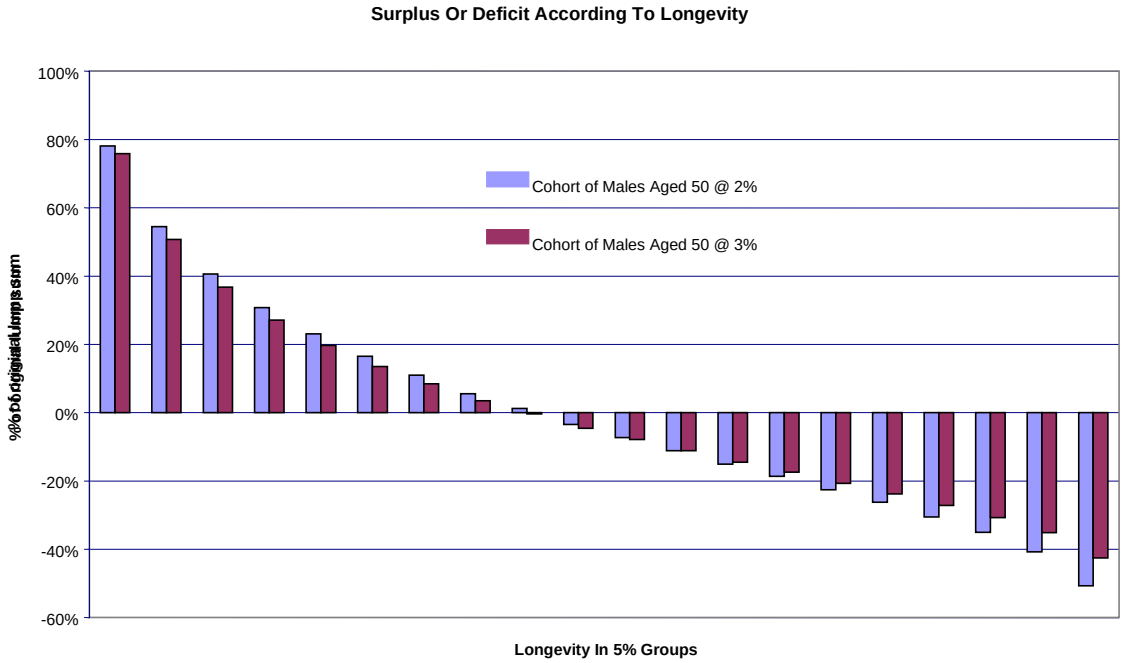



Table of Results

| Survival Group | Female 30 | | Female 50 | | Male 30 | | Male 50 | |
|---|---|---|---|---|---|---|---|---|
| | @2% | @3% | @2% | @3% | @2% | @3% | @2% | @3% |
| 95-100% | 51% | 45% | 74% | 71% | 57% | 52% | 78% | 76% |
| 90-95% | 26% | 21% | 48% | 44% | 30% | 25% | 54% | 51% |
| 85-90% | 18% | 14% | 35% | 30% | 20% | 16% | 41% | 37% |
| 80-85% | 12% | 9% | 25% | 22% | 15% | 11% | 31% | 27% |
| 75-80% | 8% | 6% | 18% | 15% | 10% | 7% | 23% | 20% |
| 70-75% | 5% | 3% | 12% | 9% | 7% | 5% | 17% | 14% |
| 65-70% | 3% | 1% | 7% | 5% | 4% | 2% | 11% | 8% |
| 60-65% | 0% | -1% | 3% | 1% | 1% | 0% | 6% | 3% |
| 55-60% | -2% | -2% | -1% | -2% | -1% | -2% | 1% | 0% |
| 50-55% | -3% | -3% | -4% | -5% | -3% | -3% | -3% | -5% |
| 45-50% | -5% | -5% | -8% | -8% | -5% | -5% | -7% | -8% |
| 40-45% | -6% | -6% | -11% | -10% | -7% | -6% | -11% | -11% |
| 35-40% | -8% | -7% | -14% | -13% | -9% | -8% | -15% | -15% |
| 30-35% | -9% | -8% | -16% | -15% | -11% | -9% | -19% | -17% |
| 25-30% | -11% | -9% | -19% | -17% | -12% | -10% | -23% | -21% |
| 20-25% | -12% | -10% | -22% | -20% | -14% | -12% | -26% | -24% |
| 15-20% | -14% | -11% | -25% | -22% | -16% | -13% | -31% | -27% |
| 10-15% | -15% | -12% | -29% | -24% | -18% | -14% | -35% | -31% |
| 5-10% | -17% | -13% | -33% | -28% | -21% | -16% | -41% | -35% |
| 0-5% | -21% | -15% | -40% | -33% | -26% | -19% | -51% | -42% |
| Lump Sum Factor | 31.1 | 25.5 | 22.5 | 19.5 | 29.1 | 24.2 | 19.8 | 17.5 |

## APPENDIX E

## DEFENDANT CLAIM PRACTITIONER'S PERSPECTIVE

### *Lump Sum system*

- Disability equates to need for total care – rehabilitation 'played down'.
- Pessimistic medical/assessment of needs – possibility of part recovery and probability of change in needs seldom considered
- Uncertain inflation forecasts produces unrealistic multipliers
- Solicitors percentage success fee basis drives up claimant's aspirations and creates further heads of damage – often too remote and/or not in the public interest
- If the claimant dies, 'windfalls' for frequently unconnected parties or those who no longer are required to provide care
- Adversarial system usually generates considerable delay between accident and compensation paid. Consequent escalation in both sides costs and need initially for sometimes unsatisfactory care provided and paid for by the State.
- Compensation 'blown' by claimant, then living on State or
- Compensation proving to be insufficient for justifiable need in long term.

### *Structured settlement system*

*Claimant*

- Early resolution of liability (not usually a problem) would enable interim payment of damages to be made to assist immediate needs
- Certainty of income whilst living (within framework) usually sought by youngsters
- Steps in payments over period(s) of time to cater for changes in need and/or inflation
- Cash 'spend' if required – often sought by the older claimant
- Quicker resolution of issues reduces time scales in periods above.

*Defendant*

- Cost savings possible by appropriate rehabilitation programs supported by Woolf reforms
- Cost savings by reducing delays
- Tax savings.

*The State*

- Less dependence on State funded care both initially and after basis of structured payments agreed.