Institute
and Faculty
of Actuaries

Setting the Personal Injury Discount Rate: Call for evidence

IFoA response to the Ministry of Justice

01 February 2019

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We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

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Institute
and Faculty
of Actuaries

Discount Rate Call for Evidence 2018
Ministry of Justice
Civil Law
Post Point 9.25
102 Petty France
London SW1H 9AJ

1 February 2019

Dear Sir/ Madam,

IFoA response to Setting the Personal Injury Discount Rate Call for Evidence 2018

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Ministry of Justice (MoJ)'s Call for Evidence into the Discount Rate. Members of our Periodical Payment Orders (PPO) Working Party, General Insurance Standards and Consultations sub-Committee and General Insurance Board have all provided input to this response. Members of the Working Party, Committee and Board have worked closely on personal injury claims over the last decade.

General Comments: introduction

2. This Call for Evidence makes reference to previous MoJ and Justice Select Committee consultations on the general theme of personal injury claims and the discount rate. The IFoA responded to the relevant consultations / Calls for Evidence, and we reiterate points made previously where relevant, in this response.

3. The IFoA is clear that the needs of injured parties should be at the centre of any compensation paid. We believe that this view is consistent with the principles established in Wells v Wells (1998), namely:

    - 100% compensation but not more or less;
    - that the claimant should be regarded as very risk averse; and
    - the way in which the claimant uses the compensation is not relevant to its determination.

4. The IFoA has a responsibility to promote actuarial science in the public interest. We have interpreted the public interest to be the requirement to provide appropriate compensation to the claimant in light of the above principles.

5. For many of the questions within this Call for Evidence, we are not in a position to provide qualitative evidence and for some of these questions, other parties should be better placed to provide a suitable evidence base. However, where possible we have made some qualitative points which we hope are helpful.

London 7th Floor · Holborn Gate · 326-330 High Holborn · London · WC1V 7PP · **Tel:** +44 (0) 20 7632 2100 · **Fax:** +44 (0) 20 7632 2111
Edinburgh Level 2 · Exchange Crescent · 7 Conference Square · Edinburgh · EH3 8RA · **Tel:** +44 (0) 131 240 1300 · **Fax:** +44 (0) 131 240 1313
Oxford 1st Floor · Park Central · 40/41 Park End Street · Oxford · OX1 1JD · **Tel:** +44 (0) 1865 268 200 · **Fax:** +44 (0) 1865 268 211
Beijing 6/F · Tower 2 · Prosper Centre · 5 Guanghua Road · Chaoyang District · Beijing China 100020 · **Tel:** +86 (10) 8573 1000 · **Fax:** +86 (10) 8573 1100
Hong Kong 2202 Tower Two · Lippo Centre · 89 Queensway · Hong Kong · **Tel:** +11 (0) 852 2147 9418 · **Fax:** +11 (0) 852 2147 2497
www.actuaries.org.uk

General Comments: PPOs

6. As referred to within the 'Evidence Requested' section of the Call for Evidence, a fundamental consideration in a personal injury settlement is the form this compensation takes; i.e. whether a lump sum or PPO. We note that the scope of this particular Call for Evidence relates to the setting of the discount rate in lump sum compensation. The bulk of our response is therefore framed on this basis. However, for completeness, we summarise our key points on the role of PPOs in personal injury compensation in this section.

7. The IFoA supports an approach that considers all settlement options and concludes on the most appropriate outcome for an individual claimant's circumstances. Claimants in personal injury cases should be fully compensated, and we believe that PPOs can often be the better solution for claimants. PPOs can avoid some of the difficulties with lump sum awards in personal injury claims, including: the estimation of life expectancy; the concern that lump sum compensation could be exhausted before death; and managing uncertainty over future investment returns.

8. As a PPO may not always be in the best interests of every claimant, we would suggest that a lump sum alternative should be considered where the claimant or their advisors can demonstrate they fully understand the risks of not accepting a PPO.

9. It is also important to recognise that the nature of many personal injury settlements is such that PPOs and lump sum awards sit alongside each other. Both PPOs and lump sums can have a specific role within an overall compensation settlement; PPOs are typically in respect of the cost of care only, although loss of earnings and case management costs may be included. That leaves many other elements of claim that are settled by lump sum.

10. Greater use of PPOs does pose challenges for non-life insurers in managing the associated risk exposure, and there are wider public interest concerns to consider, beyond the impact on a personal injury claimant. For example, any additional cost to insurers could result in higher insurance premiums, and this does have the potential to make insurance less affordable and for some people, unaffordable. More generally, to the extent that PPOs dominate the future Balance Sheets of non-life insurers, there is a potential significant impact on the security of such insurers.

11. It remains the case that any challenges insurers have in managing risks arising from PPOs are much less than the challenges individual personal injury claimants would face managing the same risks (future life expectancy, investment returns and associated costs). However, this has to be balanced against the wider impact on insurers of greater use of PPOs, including potentially higher insurance premiums. It is therefore important to take a broad perspective on the public interest, when considering the impact of legislation on personal injury claims.

12. We would be happy to have a separate discussion with MoJ on the wider merits of PPOs and implications of their use.

Comments on Call for Evidence Background

13. If a fixed rate basis is used for setting the discount rate, then we believe this will result in some inequity because the risk appetite and term profiles of individual claimants are very diverse. This also means that any actual claimant data that is provided (even though we expect that statistically significant meaningful data may not be available) will likely be misleading. Inequity of settlement amounts at an individual level is inherent in lump sum settlement for long term

liabilities. For example, where a fixed mortality assumption is made, some claimants will live beyond the expectation of life and others for shorter periods and there will be inherent variation between actual experience and the assumptions used to determine a lump sum settlement.

14. If lump sum compensation for long term contingent liabilities is set on a basis that can, on average, reasonably be expected to result in fair compensation (not grossly over or under), then at the individual level there will be over and under-compensation. Assuring full compensation to the majority of claimants would require a bias towards over-compensation.

15. We also note analysis that GAD produced for the Scottish Government on the setting of the discount rate, which is relevant to the degree of compensation. Figure 1 within this analysis [1] shows that, in the context of the baseline portfolio used, reducing the discount rate to reduce the probability of under-compensation from 50% to say 15% increases the median level of over compensation by around 15%. This analysis seems reasonable and we agree that reducing the likelihood of under-compensation will increase the extent of actual over-compensation.

16. The Background section of the Call for Evidence notes (paragraph 18) that the Lord Chancellor is required to assume *that damages are invested in a diversified portfolio …..involving more risk than a very low level of risk, but less risk than would ordinarily be accepted by a prudent and properly advised individual investor*. We have responded to the Call for Evidence questions below on this basis. However, again for completeness, we reiterate points we made in previous consultation responses on the level of investment risk assumed, below.

17. Our view is that the discount rate should be derived from a risk-free rate of return, reflecting the risk appetite of a risk-free investor. Lump sum settlements expose claimants to uncertainty over the adequacy of their compensation, and using a higher discount rate increases this risk. It is important to recognise that individuals have differing appetites to risk. Low or very low risk for one individual may mean something different to someone else. Such differences in appetite will result in different investment decisions. The variability arising from investment returns may provide additional assets for some claimants but for other claimants, poor outcomes may lead to insufficient assets for the later years of life.

18. Furthermore, our view is that the level of lump sum compensation should be distinct from any investment decisions.

Call for Evidence Questions

Q1: (a) What asset classes are generally available to claimants investing lump sum damages and suitable for the hypothetical "low-risk" investor envisaged in the setting of the discount rate?

19. A life annuity may be a suitable asset for some: it enables a claimant to cover off some of the longevity risk (but not the inflation risk). It is not possible to buy an annuity linked to the Annual Survey of Hours and Earnings (ASHE) and an annuity linked to RPI may look expensive. However, some claimants may benefit from using part of their lump sum to buy an annuity increasing at a fixed 3% per annum with a 10-year guarantee period; this type of annuity is readily available.

[1] https://www2.gov.scot/Resource/0054/00540068.pdf

(b) What asset classes are not generally available in practice to such an investor, for example due to reasons of scale, liquidity, cost-efficiency or unsuitability?

20. As noted in the Call for Evidence, we agree that direct investment in assets such as property and equities may be less practical than indirect exposure for reasons of scale and liquidity. However, we do note that it is not uncommon for lump sum settlements to be in the range £5-10 million (and beyond).

21. However, we are less convinced that index-linked gilts are impractical for direct investment. We understand that at least a range of such gilts are available to buy and sell by the general public, either on the internet or by post, subject to passing the money laundering tests of the Debt Management Office.

Q2: (a) Please provide information regarding how recipients of lump sum damages awards for future financial loss are typically advised to invest, when they are normally advised and why?

(b) Is there any regulatory material or guidance available to those providing such advice? If so, what?

(c) Does such guidance help advisers achieve a suitable and consistent approach?

(d) Do claimants follow the advice given? If not, please explain to what extent and why.

(e) Is the cost of pre-settlement financial advice given to the claimant paid by the defendant as part of the settlement? What sums are involved?

22. We do not have access to data on how recipients of damages awards are advised to invest, nor on the extent to which claimants follow this advice. We envisage that it may be difficult to access such data, and any data available could be censored which could, in turn, give an incomplete and biased view on the extent to which advice is followed.

23. However, we agree that any investment advice should likely reflect the specific characteristics of personal injury claimants. As the Call for Evidence explains, projected life expectancy will have a large bearing on the anticipated cashflow requirements of the claimant. The characteristics of some injuries will have a direct impact on limiting lifespan. Other injuries might benefit from advances in medical treatment that can alter the life expectancy of a claimant, albeit many years later and therefore unknown at the time of settlement.

Q3: (a) To what extent do changes to financial conditions affect investment advice provided to claimants who receive a lump sum award?

(b) Is there any evidence available to show how the change to the discount rate in March 2017 directly impacted upon investment advice provided to claimants?

24. We do not have evidence on the impact of the change in discount rate on investment advice provided to claimants. However, we understand that the change in the discount rate did have a marked impact on the number of PPO settlements. Analysis from our PPO working party suggests that the number of PPOs settling in 2017 had reduced by 66% from levels seen in the years 2014-2016.

Q4: (a) Please provide evidence of how recipients of lump sum damages awards actually invest, and why?

(b) What sources of balanced reliable data on investments actually made by claimants are available?

25. We do not have access to data indicating how specific claimants have invested their lump sum settlement; other parties may be better placed to provide this information.

Q5: (a) What data is available regarding the profile of claimants of lump sum damages?

(b) How are claims of loss typically split between loss of earnings and care needs, for notional investors with lump sums of around £0.5m, £1.0m and £1.5m respectively?

(c) Is a period of 30 years a reasonable overall average projection period to consider when analysing long-term investment returns from such portfolios, or would an alternative period or a range of periods be more suitable, and if so, which and why?

26. We do not have access to profiles of claimants with lump sum damages, and again other parties may be better placed to provide this information.

27. However, as mentioned above and as acknowledged by the Call for Evidence, it will be important to consider a range of data sets reflecting differing circumstances of claimants: subject to this data being available. As already noted, the specific characteristics (and personal preferences) of individual claimants will have a bearing not only on the level of their compensation, but also how they choose to invest any lump sum.

28. In relation to question 5 (c), it is not unknown for a lump sum settlement to be provided to claimants in their 20s and 30s, with a corresponding need for care for the rest of their lives. In these circumstances, a 30 year term would be insufficient. We suggest this cohort of claimants is also included in the analysis of long term returns.

Q6: What evidence is available to illustrate how the following characteristics affect investment behaviours in practice?

(a) Age and expected future lifetime (e.g. longevity risk)
(b) Size of lump sum
(c) Initial and ongoing funding requirements (e.g. care or accommodation costs)
(d) Existence and requirements of financial dependents (e.g. spouse, civil partner, children)
(e) Other protected characteristics under the Equality Act 2010 (race, sex, disability, sexual orientation, religion and belief, marriage and civil partnership, gender reassignment, pregnancy and maternity);
(f) Availability of PPOs or other sources of income.

29. We do not have any points to raise in response to this question.

Q7: (a) What taxation rates typically apply to claimants on their investment returns, and how does the distribution of these vary across ranges of different claimants?

(b) How is the effect of taxation taken into account in determining what investments to make?

(c) What might typical average current tax rates be for notional investors with lump sums of around £0.5m, £1.0m and £1.5m respectively (and no other taxable income)?

30. Other parties may be better placed to provide quantitative evidence of tax rates applicable to claimants' lump sums. However, we have a number of qualitative points in the paragraphs below.

31. We agree that it is important to consider the net of tax investment return likely to be achieved in determining the discount rate. However, given the likely variation in tax payable by individual circumstances, illustration of the impact of tax may be best considered via a range of case studies.

32. As suggested above, the impact of tax will vary from claimant to claimant depending on their circumstances. A further dimension is that for a given claimant, the impact of tax is also likely to vary over the expected duration of their claim.

33. Our comments earlier on considering a wider range of lump sums are also relevant here. The impact of income and capital gains tax could be more significant in investments made from materially larger lump sums.

Q8: What evidence is available regarding the average long-term rates of inflation which apply to costs typically experienced by claimants in aggregate, and how do these compare to each of RPI, CPI, CPIH and earnings inflation?

34. Again as noted in the Call for Evidence, we agree that different elements of a personal injury settlement would be subject to differing inflationary pressures. For example:

- compensation for earnings lost would reflect expected future increases. As noted in the Call for Evidence, an earnings-related inflation measure could be more appropriate than using the RPI index, and may be higher than RPI. One such example is the ASHE index;
- similar comments apply in relation to care costs, which would depend heavily on wage inflation for care workers;
- the ultimate inflation of costs will depend on the range of elements and balance between these elements.

Q9: (a) What investment management costs would notional investors with lump sums of around £0.5m, £1.0m and £1.5m respectively pay in practice and how are these costs broken down into different areas?

(b) To what extent would a "properly advised" investor need to incur all of these costs, for example in relation to active or passive investment of funds?

35. Investment management costs would need to take account of investment manager fees, investment expenses (dealing charges, custody and administration costs) and the costs of obtaining investment advice. Potentially these could exceed 1.5% per annum in aggregate, although if an investor was to use passive investment funds on a non-advised basis (assuming this was permissible) these costs could be as low as 0.25% per annum in aggregate. We would expect costs to be lower as a percentage of assets for larger sums, due to economies of scale, however we would expect the above ranges to be broadly applicable for all three scenarios given.

36. Unless the requirements were to be scaled back or an investor be able to request scaled-back advice (with advisers being willing to offer such services), it is unlikely to be possible to reduce

costs of advice significantly. In practice, we would expect the costs of advice to be no higher than 0.5% per annum, with the majority of costs arising from investment manager fees and expenses. These latter fees could be as low as 0.25% per annum if passive investment funds were used, but could be in excess of 1% per annum if actively managed funds were used, particularly if a “fund of funds” approach were used.

Q10: (a) Please outline your views on how well each of the notional investment portfolios (i), (ii) and (iii) set out above would match the criteria for the investment approach to be assumed under the Civil Liability Bill (as summarised in paragraph 18 of this call for evidence).

(b) Please provide your views of an asset class distribution of a portfolio which would best meet those objectives (which may or may not be aligned with one of the notional portfolios (i), (ii) or (iii) listed above).

37. Given potential difficulties in accessing data on actual investment of lump sum awards, we agree that a sensible alternative would be to consider notional investment portfolios.

38. We have already noted in our general comments that we believe that the discount rate should be derived from a risk-free rate of return, reflecting the risk appetite of a risk-free investor. However, we offer comments below reflecting the requirements of the Civil Liability Bill and the risk appetite assumed therein.

39. We consider that the model portfolios suggested by the GAD are unlikely to be suitable for the typical claimant as they appear more consistent with sophisticated investors with relatively high investment risk appetites. Private investors who underlie the data for Portfolios (i) (FTSE Private Investor Conservative Index) and (iii) (PIMFA index) appear likely to reflect more affluent members of society. Although (i) is described as conservative, it is reasonable to expect that this is ‘conservative’ in the context of a select group of relatively well-off individuals. While some claimants may be in this position, it would seem inappropriate to apply such adventurous asset allocation assumptions to the body of claimants. In theory, tailored assumptions could be set for individuals dependent on overall circumstances, but this seems impractical and likely to be considered discriminatory.

40. Furthermore, we note that each of the model investment portfolios include not insignificant equity exposure, with this exposure increasing moving from Portfolio (i) through to (iii). Similarly, portfolios (ii)/ (iii) include higher levels of investment in corporate bonds, albeit of unspecified credit quality. As the asset allocations move left to right within the portfolio table, we believe the allocations are increasingly less consistent with the implied required risk appetite of Civil Liability Bill.

41. Notwithstanding our comments above, we consider that adjustment is required to the index-linked gilt driven discount rate of -0.75% that was prescribed in 2017 as a risk-free discount rate measure. This is for a number of reasons:

- the yield on index linked gilts (reflecting RPI) is low as an indicator of the underlying risk free rate because of specific factors affecting the demand for these instruments, including from annuity providers and pension funds, particularly at the long-end;
- there is ongoing debate on whether CPI-linking is more appropriate than RPI-linking both in general as a measure of inflation and for index linked gilts. Were the government to cease issuing index linked gilts linked to RPI and instead adopt CPI, this would exacerbate the above issue;

- differential indexing may be appropriate for different types of damage. For example, if trying to replicate pension lost, statutory increases on pension accrued more recently are in line with CPI capped at 2.5%, (both in deferment and in payment). In this context, the index linked gilt yield would not reflect the CPI/RPI differential (CPI historically lower) nor the capping element. In contrast, real earnings growth would be understated if earnings were in the long term expected to increase in real terms.

Q11: Please outline your views on how the appropriateness of the portfolios outlined in Q10 would alter for claimants within a reasonable range of different characteristics under the following criteria (all other things being equal):

(a) Age and expected future lifetime
(b) Size of lump sum
(c) Initial and ongoing care funding requirements

42. As noted in our response to Q10 above, we do not believe the model portfolios are appropriate, given the implied risk appetite of the Civil Liability Bill. This view holds across likely ranges of the characteristics (a) - (c).

Q12: (a) Are there similarities between the ways that lump sums awarded in personal injury cases are invested and how individuals choose to invest other funds, for which data might be more readily available?

(b) For example, would data regarding defined contribution pension investments be of relevance – both in the way that funds are invested prior to initial withdrawal, and how these funds are managed in retirement (for example through income drawdown)?

(c) Would any other financial products be useful to consider, and if so, what data and information is available on investment decisions for such products which could be useful in this exercise to develop a proxy for how personal injury claimants might invest lump sums?

43. As with consideration of personal injury claims, in a defined contribution pension context, an individual's personal circumstances and risk appetite will have a significant bearing on how they choose to invest their pension fund. However, investment in pension drawdown as an individual nears or is in retirement may be more relevant to personal injury claims than investment in a defined contribution fund where it is in accumulation phase, particularly where there is no income required from the fund in the short/ medium term.

Q13: Do you have to any other data or evidence to provide that you consider to be relevant to this call for evidence? If so, please provide it and explain its relevance.

44. Although we do not provide evidence on the following, we note that the Call for Evidence does not seek input on a prospective view of expected returns, or their standard deviation, on different asset classes that might make up a suitable model reference.

45. One potential (but not existing) supply-side solution to the question over suitable assets for the investment of lump sums would be availability of gilts linked to the CPI index. However, as we mention in answer to Q8 above, there is a range of differing but relevant inflation pressures to consider.

Q14: Please provide evidence of how the setting of the discount rate under the new law will affect persons with protected characteristics.

46. We do not have any points to raise in response to this question.

Should you want to discuss any of the points raised please contact Steven Graham, Technical Policy Manager at Steven.Graham@actuaries.org.uk,or on 020 7632 2146 in the first instance.

Yours sincerely,

Jules Constantinou
President, Institute and Faculty of Actuaries