Institute and Faculty of Actuaries

The Personal Injury Discount Rate - How it should be set in future

IFoA response to the Ministry of Justice

9 October 2017

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The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

9 October 2017

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Dear Paul,

The Personal Injury Discount Rate - How it should be set in future

Thank you for your invitation to comment on the Ministry of Justice's response to the consultation on the Personal Injury Discount Rate. Our General Insurance Board has led the drafting of this contribution on the debate around the personal injury discount rate (PIDR).

IFoA View of the PIDR

1. The IFoA's position is unchanged from that stated in our submission to the consultation, namely that the PIDR should be very closely linked to the market based risk-free rate of return, vary accordingly and that the calculation of compensation should be independent of claimants' expected investment decisions. We state those reasons in more detail in our commentary below.

Lump Sum Award or Structured Settlement

2. While there has been a lot of focus on the PIDR, we wish to emphasise the importance of longevity risk in lump sum settlements. The proposals contain a reference to the period over which the award is made; however, this will only ever be an expected period. Individual lifespan will differ from the expected future lifespan.

3. Even if investments perform as expected, if an individual remains alive beyond the average expected lifespan, that individual will run out of money and will fall back on state, or other (e.g. family), provision to meet their needs. Similarly, if an individual dies earlier than expected, the settlement may be viewed as having been too generous, as funds will not have been exhausted by the time of death.

4. A lump sum can reflect how long an individual is expected to live; it cannot reflect how long an individual will live. In particular for some claimants, the risk that an individual will live longer than expected is the most significant uncertainty they will face.

5. For that reason, the IFoA would support any measures the MoJ can take to emphasise the importance of Periodical Payment Orders (PPOs) in transferring longevity risk away from individuals. While a PPO cannot always be in the best interest of every individual, or may not be available to courts, we would welcome an approach that considered a PPO as the

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preferred settlement option. A lump sum should only be considered when the claimant, or their advisers, can demonstrate they fully understand the risks of not accepting a PPO.

6. The IFoA recognises that PPOs are not perfect for claimants as they are currently constructed (e.g. no perfect inflation match), however, they provide the additional benefit to claimants of ensuring investment risk remains with the defendant, which is probably better placed to deal with both longevity and investment risk. PPOs are also more costly for insurers, so there may be merit in a review of the settlement framework, given the cost implications for both parties.

Investment and Inflation Risks

7. Paragraph 4 (3) (d) sets out a definition of risk for determining the selected portfolio. It appears to set upper and lower boundaries for the portfolio; namely "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 who has different financial aims"

8. We would prefer the definition of risk to be the wording contained in the proposal, that the expected return should be that of a low-risk portfolio. A simpler definition would still provide the expert panel with sufficient flexibility to determine what that should look like. This may make it easier for the panel to consider including existing, or new, insurance products within the portfolio, e.g. impaired life annuities with different indexation.

9. The IFoA's own position remains as stated in our submission to the consultation, namely that the PIDR should be very closely linked to the risk-free rate of return. This is because lump sum settlements expose claimants to uncertainty over the adequacy of settlement, as higher investment returns come with increased risk. We consider that the risks to individuals are higher than those facing institutions, which can benefit more from diversification.

10. Our view remains that the calculation of compensation should be independent of claimants' expected investment decisions. We re-stated that view after publication of the Lord Chancellor's response.

11. Claimants are also exposed to inflation risk. Lump sum awards may offer compensation in a number of different areas that would be subject to a variety of inflation measures:
    - Compensation for earnings lost would reflect expected future earnings increases;
    - Care costs would depend heavily on wage inflation for care workers; and
    - The ultimate inflation target will vary depending on each claimant's needs.

12. We would support the expert panel reviewing what the target inflation measure should be when determining the portfolio. We recognise the convenience of assessing inflation using index-linked gilts. While the simplicity of that measure will probably be understood by many claimants, we would value having greater clarity around the investment objective in respect of inflation.

Review Panel

13. The IFoA welcomes the opportunity of an actuary participating on the expert panel. However, we are concerned there is no definition of 'actuary'. While it could be possible to insist on a specific qualification, or membership of the IFoA, we would support a definition requiring that the actuary can demonstrate extensive knowledge and experience of working in the UK.

14. We would also support a requirement for the review panel to meet annually. We discuss the period of review in more detail later in this letter; however, there may be occasions when the Review Panel may recommend a review of the PIDR because of changes in market returns.

15. The current proposal allows the Review Panel to be quorate without full attendance. Given the infrequent reviews proposed and the importance of the reviews, we would expect all members of the Review Panel to be in attendance at any meetings to ensure that sufficient breadth of experience is represented in any discussions.

Frequency of Review

16. The main drawback of the current system was the infrequent change in the discount rate. Rumours of impending change would lead to a significant change in behaviour of claimants and defendants trying to rush, or delay, settlements to take advantage of any expected change. Reviewing the rate every three years does not alter that understandable desire to time the date of settlement to gain the maximum benefit. To help mitigate this risk, we would encourage the review to be completed within 90 days.

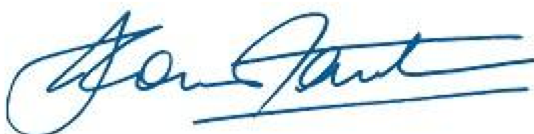
17. Three years offers sufficient time for market changing events to occur that would make the PIDR no longer fit for purpose; hence, we recommend an annual check on the suitability of the rate given current market conditions.

18. Our members have indicated that the review period is not particularly helpful in enabling insurers to set reserves given the five-year average period between the accident taking place and the date of settlement. A period of five years may cover two reviews of the PIDR. While adopting a risk-free rate could be assessed in assumptions, the more subjective approach of what defines the low-risk portfolio may create additional uncertainty in reserving assessments.

19. The IFoA's own position remains as stated in our submission to the consultation, that the rate be dynamic and defined by market rates at the point of settlement. Setting fixed PIDRs that are prescribed periodically will continue create inequities and distortions in settlements and behaviours, as well as uncertainty for insurance companies, which will be unable to effectively hedge changes in the PIDR and will remain exposed to shock reserve adjustments.

Should you wish to discuss any of the points raised in further detail please contact Philip Doggart, Technical Policy Manager (Philip.doggart@actuaries.org.uk / 0131 240 1319) in the first instance.

Yours sincerely



Jules Constantinou
President-elect, Institute and Faculty of Actuaries