



Institute
and Faculty
of Actuaries

Justice Select Committee Pre- legislative scrutiny: draft personal injury discount rate legislation inquiry

IFoA response to Justice Select Committee

16 October 2017

About the Institute and Faculty of Actuaries

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.



Mr Nick Walker
Clerk to the Justice Committee
House of Commons
London
SW1A 0AA

16 October 2017

Dear Mr Walker

Justice Select Committee Pre legislative scrutiny: draft personal injury discount rate legislation inquiry

The Institute and Faculty of Actuaries (IFoA) welcomes this opportunity to provide a written submission to the inquiry. Members of our General Insurance Board have provided most of the detail in our submission. We have also relied on information from our Working Party that has investigated Periodical Payment Orders over the last decade.

We have submitted our answers to the Committee's questions as Appendix A to this report. For completeness we have also provided the Committee with our full response to the 2017 Ministry of Justice consultation about the discount rate as Appendix B.

We set out a clear position that the discount rate should be as close to a market consistent risk-free rate as possible. We recognise the Lord Chancellor has made a different proposal about the discount rate. Our submission covers explanation for the position we hold, but also comment on the

Should you wish to call us to provide oral evidence, or to provide any additional explanation of the written evidence, please contact Mike Williams, Public Affairs Manager (Michael.Williams@actuaries.org.uk / 020 7632 1466) in the first instance.

Yours sincerely

Marjorie Ngwenya
President, Institute and Faculty of Actuaries

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Assumed rate of return on investment of damages

Summary Position

1. The Institute and Faculty of Actuaries (IFoA) is clear that the needs of injured parties should be at the centre of any compensation paid. We believe this view is consistent with the principles established in *Wells v Wells (2001)*, 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.
2. 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. If courts were to establish different principles for the settlement of claims, or if any government were to re-define the policy purpose (eg the needs of the taxpayer, as opposed to claimants), we recognise the outcome for claimants and defendants would be different.
3. We have set out our rationale for supporting these principles in this submission. In particular, we have set out the risks for claimants in respect of lump sum settlements, which we believe are important considerations in the selection of a suitable discount rate for the calculation.
4. The IFoA believes the review of the discount rate also provides an opportunity to reconsider claims settlement in general, rather than solely focussing on the discount rate. We welcome the focus that the Lord Chancellor's consultation had on Periodical Payment Orders (PPOs). The nature of many settlements is such that lump sum awards and PPOs sit alongside each other. Each has a specific role within an overall compensation settlement. While we also recognise the uniqueness of claims, we believe there are some underlying principles that should encourage a thorough review of bodily injury claims. Although this would be a matter for the courts, the IFoA would be willing to provide actuarial input to any such review.
5. While we have set out our position above in how we have approached the discount rate, we are also very aware that any change affecting claimants will also have an impact on defendants. Many actuaries work for general insurance firms that will pay compensation and we are aware that the management of large claims, whether lump sum or PPO, is a major risk for insurance companies. Similarly, the NHS faces a large number of similar claims, so the aggregate value of settlements will affect the provision of services.
6. Although this issue is secondary to this inquiry and the financial stability of insurance companies would ultimately be a matter for HM Treasury, members of the committee should be aware that changes in claims settlement will have opposite impacts for claimants and defendants.

The Government's stated objective is to "reflect actual claimant investment behaviour and ensure claimants are compensated in full neither more or less". Does the text of the draft legislation achieve this objective, and could it be better achieved by other legislative or non-legislative means?

7. We believe it is crucial to investigate what "**compensated in full neither more or less**" means in practice. The lump sum award is designed to meet loss over the expected future lifetime of the claimant. The expectation of future lifetime will be an expectation on average of a given sample of the population. In reality, very few individuals will live exactly for their expected future lifetime. As such, compensation can only ever meet the expectation of future

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lifetime costs in aggregate. Some claimants will die earlier than expected, meaning the lump sum was greater than required. However, other claimants will live for a shorter period than expected, meaning compensation is insufficient for their actual lifetime.

8. It is also important to recognise the specific characteristics of some of the injuries in bodily injury claims. Some injuries may have a direct impact on limiting lifespan. Other injuries may benefit from advances in medical treatment that can alter the life expectancy of a claimant many years after the claim settlement.
9. This longevity risk, of particular concern for claimants living longer than expected, cannot be removed once a claimant receives a lump sum. Even if investment performance matches or exceeds the assumed discount rate, a claimant living much longer than anticipated will exhaust their assets. This also does not take into account a spending pattern that may be greater at younger ages, which could accelerate further the depletion of claimants' assets.
10. We have already noted the importance of PPOs in settlement of claims. PPOs are one means of managing longevity risk. The annual compensation paid will last for a claimant's lifetime; therefore, longevity risk lies with the defendant, whether insurer or government.
11. PPOs are not perfect and are not suitable for all heads of claim. The inflation assumption within a PPO requires specific attention, as it would be simpler to increase payments in accordance with a recognised and hedgeable index. We have noted below a link to an information paper for actuaries on the specific risks arising from PPOs.¹
12. The IFoA set out a clear argument for the discount rate to be risk-free, or at very close to it, in our response to the 2017 consultation and the 2013 consultation² ³. We remain convinced that the amount of compensation should be distinct from any subsequent investment decisions.
13. Calculation of compensation is a matching exercise to determine the value of a series of cashflows. The IFoA's position is that such an exercise should be conducted on a risk-free discount rate. Index-linked gilts would provide a proxy to that rate.
14. That discount rate is different to the expected from the assets in which an investor may invest to provide cashflows from a lump sum. Investment decisions will reflect the risk appetite of individual investors. However, taking risk, or hoping for greater potential returns, in the compensation calculation means an individual may be under- or over- compensated, assuming longevity is as expected. Using a higher risk portfolio automatically leads to the possibility of not matching needs assessed in the settlement.
15. The IFoA does not believe the Government objective can be met, but that is not the issue with the draft proposal. The interaction of investment and longevity risks means that the objective will be subject to variation dependent on the claimant's experience. We would welcome acknowledgement that the objective can only ever be met on average, rather than in all individual circumstances.

¹ <https://www.actuaries.org.uk/system/files/field/document/PPO%20Information%20Paper%20Final%20Draft.pdf>

² <https://www.actuaries.org.uk/documents/ifo-response-ministry-justice-personal-injury-discount-rate-how-it-should-be-set-future>

³ <https://www.actuaries.org.uk/documents/consultation-response-ministry-justice-damages-act-1996-discount-rate-review-legal>

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16. Furthermore, we believe it is vital for claimants to understand the potential variance in outcomes, recognising the impact of longer life expectancy and variation in investment returns. There is a parallel with investors not purchasing annuities at retirement. Actual decisions to take a lump sum can have serious impact on day-to-day living outcomes for claimants.

Will the proposed legislation result in a fairer framework for (a) claimants, especially those for whom any risk would be ill-advised (b) defendants and (c) wider society? Is the move from "very low risk" to "low risk" appropriate, and are these terms clear enough?

Should the way personal injury claimants generally choose to invest lump sum damages influence how damages are calculated for all such claimants?

17. We have already covered some of the detail in our response to the previous question. The definition of a fairer framework does depend on what the Government is aiming to achieve. The IFoA is clear that a lump sum is intended to compensate claimants for injuries incurred and future losses. Fairness to those individuals should be the main feature of the framework. The cost of providing that compensation should be a secondary issue. As we noted in paragraphs 11 and 12, we do not believe future investment decisions should influence the amount of compensation.
18. It is important to recognise 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 claimants, but for other claimants, poor outcomes may lead to insufficient assets for the later years of life.
19. We refer to our response to the previous question in identifying the amount of risk a claimant should accept and our conclusion that a lump sum means claimants are taking on a significant amount of risk. A fairer framework should not mean the lump sum amount sits between what claimants (and their representatives) would like to receive and what defendants (and their representatives) would like to pay.
20. It is also important to consider who is best placed to manage risk. In general, individuals fail to recognise and manage risk effectively. Insurers and Government are much better placed to manage risk due to their expertise. Insurers and Government also benefit from pooling, whereby experience of a larger number of claims can be expected to provide more stable experience.
21. The MoJ's consultation asked a number of questions about the availability and appetite for PPOs. We recognise that PPOs are not available in all circumstances, nor are they the most suitable outcome for claimants; however, as noted before, they transfer longevity risk from the claimant to the defendant. Recognising the benefit PPOs provide should make them an integral part of a "fairer framework".
22. While PPOs provide some transfer of risk for claimants, they do offer specific challenges to non-life insurers in managing the specific risks arising from PPOs. Long-term liabilities do not sit alongside the majority of liabilities in such insurers. Our submission to the consultation suggested three ways in which some of the challenges of PPOs could be mitigated:
- Alternative indexation of PPOs;
 - Pool PPOs in an industry wide scheme: and
 - Change the way in which capital insurers must hold is calculated.

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23. While the specific issues around PPOs go beyond the remit of this inquiry, we believe there would be significant benefit from an appraisal of why PPOs are utilised in some claims, but not in others. An increase in the number of PPOs may indicate claimants are aware of the risks involved in lump sums. We would encourage HM Treasury and the MoJ to pursue the matter further, both in terms of numbers of PPOs and also in mitigating risk for insurers.
24. We would also support any work the MoJ undertook to assess the suitability of PPOs for both claimants and defendants. There is significant global variation in the settlement of personal injury claims that would provide useful evidence in settling claims. The IFoA would welcome the opportunity to participate in any such research.

How robust is the Government's analysis of the proposal and of its impact on (i) claimants (ii) insurance companies and (iii) the NHS? (Impact assessment). Who will be the main losers from the proposal and how much will they lose by?

How likely is it that changing the methodology for calculating the discount rate will result in a reduction of insurance premiums? Is the Government right to assume that insurance companies will pass on savings?

25. Changing the discount rate, methodology or value, will have an opposite impact for claimants and insurers. Increasing the discount rate, as proposed, will reduce the amount paid by insurers to claimants.
26. In terms of how much individuals would lose out, the percentage change would depend on the expected lifetime of the claimant and on the exact split of any total award. The IFoA does not gather data on individual claims.
27. Changing the discount rate is likely to have an impact on the behaviour of both claimants and defendants. A higher discount rate may encourage insurers to settle claims as lump sums, whereas claimants may view a PPO more favourably in light of the lower lump sum. It is difficult to predict changes in behaviour of either party, which will depend on specific circumstances of the claim.
28. As noted in our opening comments, management of PPOs creates specific challenges for insurers. It is worth noting that the reserving requirements for any PPO liabilities are strong. Paying a lump sum in lieu of retaining a PPO liability is, for many insurers, a more straightforward and cost-effective option, particularly if the lump sum will be lower than previously assumed.
29. The IFoA's PPO Working Party surveyed PPO settlements at the end of 2015 and noted that the larger the value of the claim the greater the likelihood it would be settled as a PPO.⁴ As yet, we have not collected any data indicating how that may alter following the change in the discount rate earlier this year.
30. Predicting the course of insurance premiums for annual contracts is not as straightforward as the question presumes. Settlement of personal bodily injury claims is only one factor of how insurers set premiums. In isolation, an increase in the discount rate would lead to lower premiums, assuming the expectation of PPO settlements remained unchanged. This reduction could be offset by an increase in the volume of claims, higher claims inflation than expected, or an increase in Insurance Premium Tax, to name but three.

⁴ <https://www.actuaries.org.uk/documents/2015-giro-survey-report-draft-pm-review>

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31. Insurance is a competitive market, especially motor insurance. The nature of that competition means that prices will fluctuate as firms seek to gain a market advantage. The competitive market may have greater impact on pricing than any single factor used to set those prices.

Who should be on the expert panel, and who should make the final decision? Are there any circumstances where the Lord Chancellor should not follow the advice of the independent expert panel?

Would it be better to review the rate more, or less, frequently than proposed (every three years)?

Does the proposal allow different discount rates to be set for different types of loss? What would be the advantages and disadvantages of this approach?

32. The IFoA set out clearly our view that the discount rate should be a market-related risk-free rate in our response to the consultation. One of the advantages of such an approach is that there would be no rate need to set up a panel to regularly review the rate. The risk-free rate would also remove any accusation of political bias towards claimants or defendants. While we would still prefer that approach as we believe it is actuarially robust, we recognise the Government's proposal has set out a different approach to the issue.
33. The IFoA is content with the composition of the panel; however, we have specific comments about the "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.
34. As noted in paragraph 31, there is potential for political views to colour any final decision about the discount rate; therefore, we do not believe it would be appropriate for the Lord Chancellor to disregard the advice of the panel.
35. We would also support a requirement for the review panel to meet annually. There may be occasions when the Review Panel may recommend a review of the discount rate because of changes in market returns.
36. 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.
37. 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.
38. Three years offers sufficient time for market changing events to occur that would make the discount rate no longer fit for purpose; hence, we recommend an annual check on the suitability of the rate given current market conditions.
39. 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

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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.

40. 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 hedge effectively changes in the discount rate and will remain exposed to significant reserve adjustments.
41. It is unclear the draft legislation does provide the opportunity to set different discount rates. The legislation refers to "the discount rate" which appears to suggest only one rate; however, we would refer this matter to those better placed than actuaries to comment on the specific wording.
42. Using different discount rates does not alter the underlying discussion about what rate should be used to set compensation. Unless the Lord Chancellor were hoping to use a market consistent risk free rate for part of the settlement, the IFoA's view of any other discount rate would remain unchanged. We do not believe the settlement should transfer investment risk to the claimant.