Institute and Faculty of Actuaries

Draft Damages (Jersey) Law

IFoA response to States of Jersey Corporate Services Scrutiny Panel

16 November 2018

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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.

Actuarial science is founded on mathematical and statistical techniques used in insurance, pension fund management and investment. Actuaries provide commercial, financial and prudential advice on the management of assets and liabilities, particularly over the long term, and this long term view is reflected in our approach to analysing policy developments. A rigorous examination system, programme of continuous professional development and a professional code of conduct supports high standards and reflects the significant role of the profession in society.

Institute and Faculty of Actuaries

Corporate Services Scrutiny Panel
States Greffe
Morier House
Halkett Place
St Helier
Jersey
JE1 1DD

16 November 2018

Dear Sir/ Madam,

IFoA response to Draft Damages (Jersey) Law

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the States of Jersey Draft Damages (Jersey) Law. We are grateful for the opportunity to respond to a slightly later timetable, and this has given us more scope to consider the draft legislation in detail. However, in the relatively limited time available, there are aspects that we have not been able to fully consider or articulate in this response.

2. 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 PPOs and personal injury claims over the last decade.

General Comments

3. The 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 (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. If courts were to establish different principles for the settlement of claims, or if the Government of the States of Jersey 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.

5. As referred to in the draft legislation (Appendix 2), the IFoA responded to related UK Ministry of Justice and Scottish Government consultations on personal injury/damages discount rates. We have drawn on points made in these responses below, where relevant; we have also submitted these responses with this one. As you will realise, these separate responses include points less relevant to the Jersey legislation; there are also some further specific features of the Jersey legislation not covered there, and we refer to these aspects briefly in this response.

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

6. We would welcome the opportunity to discuss this response with the Scrutiny Panel in more detail. In particular, we would be very happy to provide oral evidence or any additional explanation of our comments if that were of value to the Panel.

Periodical Payment Orders

7. The IFoA supports the use of PPOs, and the legislation prescribing the power to courts in Jersey to impose a PPO. Claimants in personal injury cases should be fully compensated, and as we have said in other responses, we believe that PPOs can often be the better solution for claimants.

8. As noted in the draft Jersey legislation (background), 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.

9. In relation to managing longevity risk (estimating future life expectancy), it is important to recognise the specific characteristics of some injuries in personal injury claims. In some cases they 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. Therefore the life expectancy of a particular claimant could be particularly influenced by their personal circumstances.

10. It is also important to note that even if an individual's expected future lifespan is modified for circumstances at the time of claim, the individual will almost always live either longer or less than expected, with a significant chance of the lump sum compensation being exhausted before death.

11. The IFoA would support an approach that considered a PPO as the preferred settlement option in personal injury claims. A PPO may not always be in the best interests of every claimant, but 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.

12. 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; this point is acknowledged in the draft legislation. Both PPOs and lump sums can have a specific role within an overall compensation settlement. In an English/ Welsh context, 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 'heads of claim' that are settled by lump sum.

13. This means there would not be cases settled only via a PPO. The PPO element is likely to be the largest part of the total cost, when a PPO is part of an award. However, there are a number of situations where a PPO would likely not be made available, and most of these revolve around the compensation level being limited.

14. We note the draft legislation allows for PPO claimants to apply for a variation to their claim subject to their being a material change in their circumstances, but with no limit to the number of such variations. This contrasts with the situation in England and Wales, where there is an upper limit of one such variation. We can envisage debate over the materiality of any change in circumstances, and whether it then merited a variation in claim. It may therefore be useful to provide further context on the requirements for such changes to be considered material, such as particular change in a specified medical condition.

15. The intention of allowing multiple variations to ensure compensation remains fair following a change in a claimant's circumstances appears reasonable. However, it does give rise to a number of practical questions and potential unintended consequences:

- could PPO payments be *reduced* if appropriate, or would variation largely apply in one direction only (upwards)?; and if the latter would this be fair to all parties?;
- if PPO payments could be reduced, for example due to an unexpected improvement in the medical condition or injury (e.g. either through underlying improvement or due to a future medical advance), what would trigger a review?
- would there be an independent mechanism to monitor changes to a claimant's circumstances, and whether there had been a material change? Any such mechanism would also presumably come at a cost;
    - if, in the absence of any independent monitoring, applications for a variation were triggered on behalf of the claimant, there may then be a bias to upwards variations in practice;
- if variation orders were expected to have an upwards bias, this could then have an adverse impact on insurers' capital requirements (see below).

16. As acknowledged in the draft legislation, greater use of PPOs does pose challenges for non-life insurers in managing the associated risk exposure. The reserving and capital requirements of PPO are strong, and paying a lump sum in lieu of a PPO liability is more certain, more straightforward and cost- effective for many insurers. There would also be further uncertainty over PPO valuation where multiple variation orders were possible. In addition, the longer term nature of a PPO liability is very different to the majority of (shorter term) liabilities of such insurers, which in itself has several implications.

17. There are wider public interest concerns to consider, beyond the impact on a personal injury claimant. Where providing PPOs involves insurers taking more risk (compared with lump sum compensation), the investors of the insurers would require additional return to compensate for this additional risk. 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.

18. Some of the challenges and disadvantages of PPOs could be mitigated by performing a review of the structure of PPO settlement, for example by:

- alternative indexation of PPOs;
- pooling PPOs in an industry-wide scheme: and
- changing the way in which capital insurers must hold is calculated.

19. Notwithstanding this however, 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). It is therefore important to take a broad perspective on the public interest, when considering the impact of legislation on personal injury claims.

The Discount Rate

20. We note the proposal to set the discount rate by statute, replacing the current arrangement of being set by courts on a case by case basis. As the draft legislation notes, this proposed approach has similarities with the corresponding legislation in England and Wales.

21. We also note the recommendation to determine the discount rate from the expected returns from a low-risk diversified portfolio. Our view however 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. Note also that under Solvency II (the EU-wide insurance regulatory framework), insurers are required to use a risk free rate to value PPO liabilities.

22. The representative portfolios used to derive the recommended discount rates include not insignificant exposure to equity and hedge fund investment. It is important to recognise that different individuals will 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 differing investment decisions. The variability arising from investment returns may provide additional assets for some individuals; but for other claimants, poor outcomes may lead to insufficient assets in the later years of life.

23. The derivation of the recommended discount rate considers the relationship between RPI and wage inflation. Given that the long term payments being discounted are expected to be wage-related, we welcome this approach in establishing the rates. The assumed low risk portfolios are referred to as appropriate ‘under proper advice’; however the rate derived does not deduct an explicit allowance for such expenses which is inconsistent. Furthermore, we believe allowance should also be made for investment expenses, including the cost of advice and ongoing investment fees/management charges.

24. Uncertainty over wage inflation may however add a further layer of complexity. It is plausible that in a relatively small jurisdiction such as Jersey, care cost inflation could be quite volatile, depending on the availability of care expertise and on general demographics. This could make awarding of lump sums more uncertain for the claimant. For example, if the cost of care increased substantially to attract care expertise 10 years hence, would investment returns be able to cover them? *A similar dynamic could make the valuation of PPOs more uncertain for insurers*.

25. Lump sum compensation may be exempt from tax but, whilst we are not familiar with the precise details of the taxation framework in Jersey, we presume that subsequent income from investing the lump sum would be subject to some form of taxation. For seriously-injured young people, the lump sum and hence annual income derived from this could be substantial. In such circumstances some tax may well be payable and this should also then be factored into the calculation of the discount rate.

26. The draft legislation includes a provision that, following any subsequent review, the discount rate would be not be less than 0%. This restriction does not apply in England and Wales. We note the rationale for this limit: a negative rate would correspond to extreme (adverse) economic conditions, and under such circumstances, deviation from the full compensation principle could be considered more appropriate. However, personal injury claimants – given they would be seriously injured – may be particularly vulnerable during such economic conditions. It is therefore not clear to us that they would then be in relatively less need for full compensation.

27. We note that the recommended discount rates are ‘stepped’ in nature i.e. 0.5% per annum if the expected loss is 20 years or less, and 1.8% per annum if the expected loss exceeds 20 years. Furthermore, the relevant single rate would apply for the duration of the claim, based on the expected duration at outset.

28. The abrupt change in discount rate after a 20 year expected duration could give rise to practical difficulties where the expected lifespan of the claimant were *around* 20 years. Substantially different lump sums could be payable to claimants with 19 versus 21 year expected remaining lifespans.

29. Where expected future lifespans were in the region of 20 years, the proposed stepped basis could then generate significant debate/ argument. One potential solution to this would be to apply a single discount rate to all claim payments within a specified duration, and then apply a separate discount rate to any subsequent payments. Using the duration/ discount rates in the draft legislation for illustration, this would mean applying a 0.5% per annum discount rate to all expected payments within 20 years from outset. However, a revision to the scope of any stepped discount rate should then reconsider the pre/ post step discount rates, and also timing of any such step.

Should you wish to discuss any of the points raised in further detail please contact me (steven.graham@actuaries.org.uk / 0207 632 2146) in the first instance.

Yours sincerely

Steven Graham

Technical Policy Manager
On behalf of Institute and Faculty of Actuaries