Policy briefing

CII

March 2017

Over a precipice: a fall in the Discount Rate for motor insurance and liability – market implications

On 27 February, the Lord Chancellor announced that the discount (or 'Ogden') rate used to calculate personal injury claims has been reduced from 2.5% to -0.75%, with effect from 20 March 2017. This implies that the Government expects that a claim recipient investing the damages settlement over their remaining life would get a negative return on investment, and the insurer must top up the expected loss. This is having significant implications on the motor and indemnity insurance markets.

Although a correction in the rate was expected by most observers in both sides of the debate, nobody expected the fall to be so severe as to send it into negative values. The announcement follows a long period of inactivity following a consultation and even a legal challenge for further consultation.

The announcement was met with a phalanx of criticism from across the sector, highlighting the implications of the significant drop in the Discount Rate, and the fact that this will transmit to higher premiums for 36 million policy holders motor and liability policy holders, particularly those with higher risks of claiming such as young drivers or commercial users.

What is the Discount Rate?

The Discount Rate (also called the Ogden rate) lies at the heart of the actuarial approach for calculating pecuniary personal injury damages, particularly under motor and liability policies.

This principle of full compensation – neither more, nor less – is a cornerstone of the law of damages. The Discount Rate is described by Kennedy Legal Services as follows:[1]

> If an injured claimant settles his claim on a lump-sum basis, should it not be assumed he will accept some investment risk? Traditionally compensation in personal injury claims has settled by way of a single lump sum award intended to last for the duration of a claimant's life. The purpose of the award is to put the claimant in the same position as he would have been had he not been injured.
>
> Compensation may include future losses, for example, future care and/or earnings. These have to be calculated by applying a "multiplier" to the amount for annual future loss. However, if payment of those future losses occurs at the time of settlement - even though those losses may not be incurred until some future date – the claimant is taking the benefit of accelerated receipt. He or she could then invest his damages to generate an additional annual return. Accordingly, to avoid over compensation, a discount is

[1] See Kennedy's Legal Services http://www.kennedyslaw.com/article/kennedysresponsetothediscountrateconsultationmay2013/ (accessed March 2017).

applied when calculating future losses to reflect the projected rate of return for a claimant's investment, and this is known as the "Discount Rate".

In a case in 1998 known as Wells v Wells, the House of Lords decided a claimant should be assumed to invest his damages in Index-Linked Government Stocks (ILGS). As the net of tax rate of return on ILGS over a three year period was 3%, the Discount Rate was reduced to this level. The House of Lords also made it clear *how* claimants actually invest their damages was irrelevant.

The House of Lords adopted this approach in 1998 because it decided that claimants in personal injury cases were not in the same position as ordinary investors and what was prudent for ordinary investors, who could ride out difficult times, was not necessarily prudent for personal injury claimants, particularly ones suffering from serious long term illness or disability. Such claimants, the House of Lords thought, needed an investment which would be certain to bring the money they needed when they required it without shortfall. These investors could not leave the ability to pay for essential services to the risk of fluctuations of the investment market. The rate of return obtainable from their investments would therefore be determined by their limited appetite for risk.

Background

The current legal parameters relating to the setting of the Discount Rate are defined by section 1 of the *Damages Act 1996* and the decision of the House of Lords in the 1998 case of *Wells v Wells*. In that case the House of Lords set the Discount Rate to be applied by the courts at 3% largely by reference to a three year average rate of return on ILGS.

In 2001 (2002 in Scotland), the Lord Chancellor announced that the rate be set to 2.5% with reference to the ILGS yields at the time, along with assumptions about the market's general explanation of inflation and other matters.

However within a decade or so, the need to review the Discount Rate and more importantly the process behind the calculation of personal injury awards became clear. The Government issued a consultation in 2012 and a second focusing more closely on the Discount Rate itself was run in February to May 2016.[2] It looked at two issues

- First, whether the legal parameters governing the way in which the discount rate is calculated produce a rate that is as 'right' as it ought reasonably to be so that the person injured is fully compensated but not overcompensated or under-compensated.
- Secondly, given the potential problems with the long term adequacy of lump sum awards, the paper examined whether there is a case for encouraging the use of other methods such as Periodical Payment Orders.

After these consultations, a government panel was established involving the industry, but then no action was taken for over three years. Then on 7 December 2016, the new Lord Chancellor issued a statement that just the Discount Rate will be reviewed by January, and this was subsequently pushed back to February.

Many stakeholders reacted sharply to just a change in the Discount Rate:

- the Association of British Insurers (ABI) launched a legal challenge of the decision to just renew the Discount Rate without consultation, and highlighted the need to change methodology.[3]
- Insurers generally were against a change in the Discount Rate. This infers that a claims recipient would receive a low return on investment should they invest the damages amount over time, and they argue that in practice this would not happen.

---

[2] Ministry of Justice, Department of Justice for Northern Ireland, and the Scottish Government, Damages Act 1996: Discount Rate Review of the Legal Framework, Consultation Paper CP 3/2013, 12 Feb 2013.

[3] Association of British Insurers, ABI launches legal challenge to Lord Chancellor's decision to review discount rate for personal injury damages, 19 Dec 2016.

- Others such as personal injury lawyers and consumer groups argued that a correction was necessary, but shared the view that the process should be reviewed more fundamentally.

By the end of the January, all stakeholders knew a change in the Discount Rate would be applied, but nobody expected the correction to be as significant as it turned out to be. Reducing it to negative values in line with Government Bond yields, suggests not a low but a negative return on investment (ie infringing the capital).

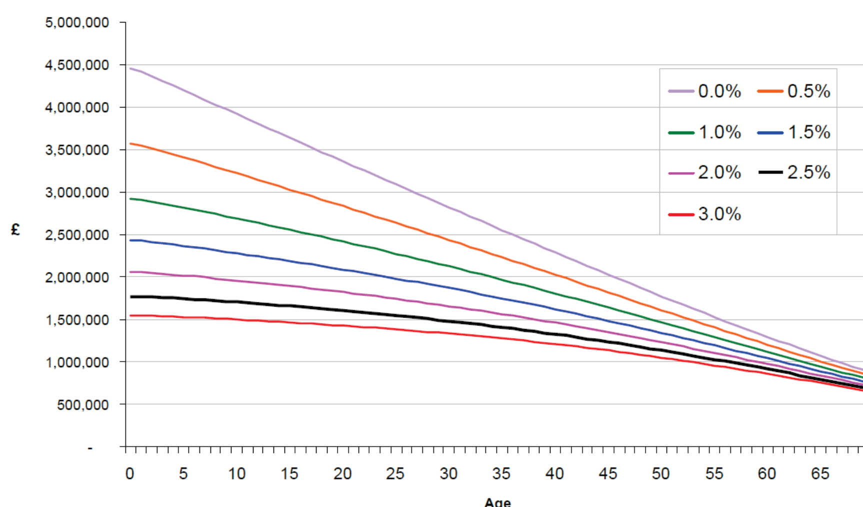
The Issues

There has been a strong view that the Government should fundamentally review its approach to personal injury compensation, and many stakeholders are perplexed at the abatement of policy activity in this area in 2013. There are three broad issues that have been conveyed in the dialogue. The first is about the use of a Discount Rate itself, the second is about the need for a more basic review of damages compensation, and the third is the example the Government's recent approach sets more fundamentally in terms of public policy.

The need for a more sophisticated formula

The first issue is the use of a single Discount Rate to calculate the lump sum adjustment. The Government itself has conceded that "the application of the Discount Rate can have a very significant effect on the size of some awards. The scale of the impact of the Discount Rate in a particular case will be affected by a number of factors." This impact is complex as can be clearly illustrated in Figure 1.

Figure 1: Example of different Discount Rates:
Illustration of lump sum compensation payments for life time compensation of £50,000 per year (in real terms) for a male for different Discount Rates and ages (based on table 1 of the Ogden tables).



Source: MoJ Discount Rate consultation (see footnote).

Industry has long called for a more sophisticated formula to determine the adjustment, as the case for other EU countries.[4] One problem with the Discount Rate based simply on ILGS gross redemption yields is that the long-term investment behaviour of those compensated is in practice very different: somebody making a long-term investment simply *not* get a negative return. In Europe for example, the adjustment is typically 1–4%.

The problem with the Discount Rate approach is that it is set on the basis of investments that the hypothetical claimant is considered ought to make. Actual claimants are free to spend their awards as they wish. Although actual investment decisions do not dictate the investments to be used in setting the Discount Rate, the present law may be

[4] See for example, the Association of British Insurers, The Discount Rate – we need a fair solution for claimants and premium payers, December 2016.

criticised on the ground that the assumptions about the hypothetical claimant made in *Wells v Wells* are too far removed from reality to be a valid basis for identifying the investments that a hypothetical claimant is reasonably to be expected to make.

In considering information about investments, allowance may need to be made for the possibility that current investment patterns may not reflect individuals' real preferred risk appetites.

This may be for a number of reasons including:

- If claimants are under compensated as a result of an unduly high Discount Rate they may be forced to invest in a riskier basket of assets in order to generate the returns they require to meet their expenses as they arise.
- Investment opportunities under ILGS are not available to meet their desired consumption profile.
- The claimant's immediate needs may have reduced the amount of the award available for investment to a greater extent than the claimant would have ideally desired: for example, during negotiations the claimant may have increased the proportion of the overall award taken as a lump sum rather than as periodical payments so as to obtain the capital required to extend or adapt his or her home to make it suitable for occupation.

Explore other approaches to compensation including Periodical Payment Orders

Another criticism that has been made is that the Discount Rate is set without taking into account the availability of periodical payment orders. The argument is that a claimant can wholly or at least largely avoid the risk of future shortfall in meeting loss or expense by taking an award in the form of periodical payments. If a periodical payment order is available, a rational knowledgeable claimant would perhaps choose a capitalised lump sum if a better investment return might be obtained than the Discount Rate.

Section 2 of the Damages Act 1996 allows courts to award periodical payments with the consent of the parties, and the requirement to seek parties consent was removed after an amendment to the Damages Act in April 2005.[5] The International Underwriting Association undertook two detailed study of this subject in 2010 and 2011, arguing that they transfer mortality and investment risk from the claimant to general insurers although claimants then take on the credit risk of the insurer defaulting at some time in the future when a payment is due.[6] The NHS Litigation Authority concurred with their view, concluding:

> "Many claimants, especially in maternity incidents, are best served by receiving their damages payments over the period of their life, usually in annual amounts to pay for their continuing needs. We encourage these Periodical Payment Orders for most high value, personal injury claims which are likely to extend over a long period, because they represent the fairest method of payment both for the recipient and for the NHS. The financial provision necessary to cover these large liabilities has been identified by the NHSLA and had increased by more than 26% at the year-end to £3,040m across 1,116 Orders (up by 20%)."[7]

Periodical payments orders can take a number of forms.

- They can be variable: the amounts payable can be reassessed in the light of changing circumstance: for example, significant deterioration or improvement of the claimant's condition. Very few of these orders are thought to be made.
- Stepped orders, where the amount payable from time to time varies in accordance with the order as originally made, are more common.

---

[5] Under the Courts Act 2003, s.100.

[6] International Underwriting Association, Periodic Payment Orders Revisited, GIRO Working Party 2011.

[7] National Health Service Litigation Authority, Annual Report and Accounts 2011-12, p.16.

- The most common form of periodical payment orders are orders where the payments can simply be index-linked to a variety of indices, including, for example, the Retail Price Index and an index taking into account the statistical surveys of hours and earnings.

The hypothetical rational claimant would invest in a way consistent with the investing population as a whole – judging which option gives a better return – rather than adopt the necessarily risk averse behaviour assumed under the present law.

On the other hand, there may be difficulties in allowing for the existence of periodical payment orders in setting the Discount Rate. In reality claimants may not always choose rationally and may lose out by taking a lump sum calculated on a higher Discount Rate, when rationally they should have chosen a periodical payment order.

Government policy process and lack of transparency

Another more fundamental issue at stake here is the process by which the Government has settled on a change in the Discount Rate.

- The Government undertook a consultation process highlighting the importance of a considered process and acknowledging itself that there were issues over and above just the Discount Rate;
- This was followed by a period of inactivity for over three years; then
- It took a decision on its own to reduce the Discount Rate by a significant margin.

The Chancellor of the Exchequer (and Economic Secretary to the Treasury) did finally agree a meeting directly after the decision was announced, and organised a summit with 16 senior people within the sector including all the major firms and the trade associations, and issuing a joint statement:

> "Claimants must get the money they're entitled to following an injury in order to support their future needs. "It is important that going forward, personal injury Discount Rates are set at a level that is fair to both claimants and consumers. The government will progress urgently with a consultation on the framework for setting future rates, and bring forward any necessary legislation at an early stage. The industry will contribute fully to the upcoming consultation, and the government will carefully consider all evidence and arguments submitted."

Implications of the correction

The Discount Rate decision is having a significant impact on motor and liability lines, as well as public authorities that pay compensation such as the NHS. As illustrated in Figure 1, even minor changes in the Discount Rate have a significant impact on claims amounts, which have to be absorbed by the insurer. A significant correction from 2.5% to -0.75% would be quite considerable.

This would be beneficial to claims recipients (depending of course on when the claim is settled: those settled before 20 March will be very disappointed).

However the impact on insurers would be quite significant. Even before the Lord Chancellor's announcement on the extent of the correction, Belgian insurance group Ageas said that it will incur a €55m (£47.3m) hit to its fourth quarter 2016 results because of the expected cut in the personal injury Discount Rate in the UK. This was based on a 1.5 percentage point reduction in the insurer's internally applied Discount Rate to 1% from the current 2.5%.[8] The

[8] See for example Ageas to take a big profit hit over discount rate, by Ben Dyson, Insurance Times, 8 Feb 2017.

announcement did not reflect the reduction that actually turned out to be 3.25 percentage points. Several insurers warned of the implications, and Direct Line said that it would be delaying its annual results.[9]

The management consultancies have given a view on the impact on premiums. EY had estimated that a move to -0.5% would send this to £2.9bn reserving impact across the sector, adding about £24 to the average motor annual premiums; while a move to -1% would result in a £3.8bn hit, adding £31 to average motor premiums.[10] Then PriceWaterhouseCoopers took the view that "as a direct result of this change, we anticipate an increase of £50–£75 on an average comprehensive motor insurance policy, with higher increases for younger and older drivers: potentially up to £1,000 for younger drivers (18-22 year olds) and a rise of up to £300 for older drivers (over 65 years old)."[11]

Context of other activities: Insurance Premium Tax

Other stakeholders including ourselves have highlighted that this significant pressures on premiums in motor and liability policies comes at a time when the premium-paying public are being particularly affected by the impacts of developments such as increases in Insurance Premium Tax (IPT). On the latter, across 19 months of successive Chancellor statements, IPT effectively doubled from 6–12%:

- The Autumn Statement in November 2015 announced an IPT rise from 6–9.5%;
- The Budget Statement in April 2016 announced another increase from 9.5% to 10%; and
- The Autumn Statement in November 2016 announced another increase from 10%–12% with effect from June 2017.

The CII issued the following statement on 27 February 2017:

"We are concerned by the extent of the Discount Rate cut, its timing and the degree of unintended consequence. There is no escaping that this reduction will ultimately be borne by the premium-paying public which may discourage many from insuring against the risks we all face. It particularly comes at a time when both insurance and protection gap issues are being highlighted, and premiums are being affected by other big developments such as rises in Insurance Premium Tax. Insurers will undoubtedly work hard to soften the blow on customers through efficiencies but there is only so much they can be expected to do. If a correction in the Discount Rate really is necessary, we would have preferred a gradual soft landing rather than a cliff-edge plummet."

Meanwhile AIRMIC (the association for those with responsibility for risk management and insurance in particularly large firms as well as smaller and medium sized businesses) highlighted that "the announcement came just four months before a significant rise in insurance premium tax (IPT) comes into force. In a challenging market for insurers, the cumulative effect of these changes will inevitability feed through into price rises for policyholders. The impact won't be felt overnight but slow-burn issues can be more damaging in the long run as they are less visible."

The RAC (an insurance broker as well as a motor club) said: "This move will increase the total amount of compensation awarded in every such case and this will instantly increase the cost of motor insurance premiums as insurers pass on the costs. This will be exacerbated still further in June when another 2% is added to insurance premium tax. […] Even before this, research for the latest RAC Report on Motoring found that motorists are already feeling the effect of higher premiums with the cost of insurance being ranked as the fifth biggest motoring concern, and now sadly these changes will only make things worse."

CII Policy & Public Affairs
March 2017

---

[9] Direct Line delays results to await review of PI discount rate, Stock Market Wire, 20 Feb 2017.

[10] Insurers face huge bill as negative discount rate is announced, by Ben Dyson, Insurance Times, 27 Feb 2017.

[11] Ogden rate change - PwC comments on impacts for motor insurance pricing, comment by Mohammad Khan, UK general insurance leader, PwC Press Room, 27 Feb 2017.