Premium Rate numbers in future loss claims

In this article, Simon Paley considers some of the consequences of the Lord Chancellor's recent change in the Discount Rate.

When personal injury and clinical negligence compensation payments relate to a loss of income arising over a number of years, a multiplier/multiplicand approach is conventionally adopted. In these circumstances, the multiplier is determined by reference to the Discount Rate (via the Ogden Tables under a formula that also takes into account employment and mortality risks). The Discount Rate is commonly defined as the net rate of return the claimant might expect to receive from a reasonably prudent investment of the lump sum. In simple terms, the higher the Discount Rate, the lower the compensation lump sum required.

The Discount Rate was established at 2.5% in 2001, assessed by the then Lord Chancellor, Lord Irvine, by reference to the prevailing average redemption yields on Index-Linked Government Stock (ILGS). ILGS yields are deemed relevant as claimants are treated as risk-averse investors, who would be financially dependent on the lump sum.

Despite significant fluctuations in ILGS yields since 2001 – almost exclusively below the 2.5% rate - the prescribed Discount Rate remained unchanged. This stasis certainly gave rise to certainty in claims settlement.

However, this state of affairs wasn't universally welcomed. For many years, there was lobbying for a change; lawyers acting on behalf of claimants argued that a lower discount was required to adequately compensate losses, whilst insurers asserted that the discount rate should not be measured by reference to ILGS yields, as most claimants would not exclusively invest the lump sum in Gilts and would instead more likely retain a balanced portfolio with an enhanced investment return. Nevertheless, despite consultations by the Ministry of Justice in 2012 and 2013, no new guidance was issued.

In response to frustration vented by the Association of Personal Injury Lawyers, the Lord Chancellor Liz Truss confirmed in December 2016 that an immediate review would be undertaken. Then, at the end of February 2017, she announced a reduction in the Discount Rate from 2.5% to minus 0.75%, effective from 20 March 2017.

This reduction went significantly further than most had predicted. Most observers had expected the rate to perhaps fall to somewhere in the range 1% to 1.5%. Overnight, this will result in a dramatic increase in compensation claims.

As a simple example, let us take a 40-year old man with net post-tax earnings of £20,000 per annum, who as a result of a road traffic accident is unable to work and so suffers a complete loss of earnings to planned retirement aged 65 years. Using the 7th Edition of the Ogden Tables, and applying a 2.5% Discount Rate, the multiplier to pension age 65 was previously 18.09 (for the purposes of this simple example, I have ignored the effect of contingencies other than mortality). Now, following the Lord Chancellor's February 2017 announcement, the equivalent multiplier is around 26.5 (the current version of the Ogden Tables does not provide multipliers for a minus 0.75% Discount Rate, so this multiplier has been estimated using interpolation – presumably a revised edition of the Ogden Tables will soon be published to deal with this potential problem). In our example, the change in the Discount Rate means that the claim for lost future earnings would, in broad terms, increase from around £362,000 (under the previous rate) to around £530,000 (under the adjusted rate) – an increase of more than 46%.

No doubt there will be many disappointed claimants who settled their claims in the months before February 2017.

It is noteworthy from our example that the new multiplier for loss of earnings from age 40 to retirement age 65 (a 25-year period) is 26.5. In other words, due to the negative Discount Rate each future year attracts a loss multiple of greater than 1. Hence, to compensate a future loss of £20,000 per annum, we must now pay a sum in excess of £20,000. At first blush, this seems counter-intuitive. Indeed, it seems that the use of the term "Discount" Rate is paradoxical, as there is no longer a "discount" applied to future losses. Perhaps we should call it a "Premium" Rate. Consequently, there is now less incentive for insurers to expediently settle claims.

Whilst our example focused on lost future earnings, the change in the Discount Rate will have similar effects on future care costs and pension losses.

We discuss some of the key consequences of this rate change below:

From a practical perspective, lawyers everywhere will be brushing down their Ogden Tables and recalibrating claims and settlement offers to reflect the new Discount Rate. The rate applies retrospectively to all claims in the pipeline, as well as to new claims.

Insurers' reserves on past claims not yet settled have become woefully inadequate. According to analysis by Direct Line made before the Lord Chancellor's announcement, a 1% decrease in the Discount Rate would take £190 million off its profits. Expanding this for the actual rate reduction of 3.25%, the adverse impact is more than £600 million each year.

There is little doubt that insurers will look to pass on this cost, through increased insurance charges to consumers. The increase in motor premiums has been estimated by some industry observers in the range £50 to £75 per annum.

Moreover, it is perhaps possible that insurers will now look upon periodic payments as an appealing alternative. Traditionally, a lot of insurers have steered clear of periodic payments, maybe due to a desire to close the file when a claim is settled. The Government has long-advocated periodic payments, and they are conventionally offered in NHS settlements, and there is a continued consultation regarding the use and application of them. One issue to be considered is whether there should be an inter-relationship between the Discount Rate applied and the offer of a periodic payment; in particular, if a claimant declines a periodic payment without good reason, should they be entitled to the beneficial Discount Rate when assessing the lump sum alternative?

The impact on clinical negligence claims will put the finances of the NHS under further strain. The rate change has been projected to cost the NHS around an additional £1 billion annually (an increase of around 60%). The Government has committed to help the NHS Litigation Authority meet its increased liability for clinical negligence costs.

Whilst some of the figures quoted above might seem startling, I should add that this is due to it being the first rate change in 16 years. No doubt, had the Discount Rate been adjusted marginally during the intervening years, it would not have become such a bone of contention. Going forwards, it is possible that a mechanism will be put in place to facilitate the regular review (and adjustment if necessary) of the Discount Rate. Good news for Ogden enthusiasts, actuaries and forensic accountants alike!