Advanced claims

820 2017 edition

Web update 1: 30 March 2017

Please note the following update to your copy of the 2017 edition of the **820** study text:

Chapter 7, section B3, page 7/9

Please add the following new section to your study text:

B3B The discount rate

The 'discount rate' is used in the process of calculating the damages that are paid to seriously injured individuals in relation to future losses and expenses. These damages are adjusted using the discount rate to reflect the fact that they are received in advance of such losses and expenses and are invested to generate a return. Thus the discount rate reflects the level of return that an individual can reasonably expect to achieve through investing their damages fund.

Example

If an injured person requires care for 10 years at a cost of £100,000 a year then it may seem sensible to pay the claimant a lump sum of 10 x £100,000 = £1m. However, the claimant can invest this money and earn interest. So, if an award of £1m is made to the claimant then at the end of the 10-year period there will be some money left over, made up of accrued aggregated interest. Essentially, the claimant will have been over compensated and so a 'discount' is applied to the lump sum calculation to address the issue of over compensation.

The Lord Chancellor is obliged to keep the discount rate under review in line with the provisions of s.1 of **The Damages Act 1996**. However, the discount rate has remained unchanged, at +2.5%, since it was last varied in 2001.

On 27 February 2017, Liz Truss, the Secretary of State for Justice and Lord Chancellor, announced the outcome of her statutory consultation into the level of the discount rate. She announced that a new discount rate has been set, which will be –0.75%. This will come into force on 20 March 2017, when the new rate will apply to all future loss settlements made on a lump sum basis after this date.

Immediate consequences

This issue is of particular interest to liability and motor insurers. The change to the discount rate will inflate the cost of lump sum payments made to claimants by insurers.

Example

A 21-year-old male has a serious brain injury and requires ongoing medical care.

His future losses may have been calculated at £8,242,086 applying a discount rate of +2.5%.

However, the change in rate to –0.75% inflates the future care cost to £19,193,161 – an increase of over 120%.

Further consequences

Motor insurers, and most liability insurers, will have reinsurance protection and the cost of this change is likely to be met primarily by the reinsurance industry. However, in the longer term reinsurance premiums will rise and the cost of this increase will be passed down to policyholders. PwC estimate the total reserve impact on the industry at about £7bn, which translates to an increase in motor insurance premiums of about £75 a vehicle (although premiums for young drivers are expected to increase substantially and possibly by as much as an additional £1,000 per annum). The change to the discount rate means that insurers and reinsurers need to quickly reassess their reserves.

Consequences for the claims manager

Each claim file relating to third parties claiming for future losses will have to be thoroughly reviewed and the new discount rate applied to the sums involved. This will result in the need to significantly increase reserves.