Committee for Justice

OFFICIAL REPORT (Hansard)

Damages (Process for Setting Rate of Return) Regulations (Northern Ireland) 2024: Government Actuary’s Department

30 May 2024

NORTHERN IRELAND ASSEMBLY

Committee for Justice

Damages (Process for Setting Rate of Return) Regulations (Northern Ireland) 2024: Government Actuary's Department

30 May 2024

Members present for all or part of the proceedings:
Ms Joanne Bunting (Chairperson)
Miss Deirdre Hargey (Deputy Chairperson)
Mr Stewart Dickson
Mr Alex Easton
Mrs Sinéad Ennis
Mrs Ciara Ferguson
Mr Justin McNulty

Witnesses:

Mr Paul Butcher	Government Actuary's Department
Mr Stephen Humphrey	Government Actuary's Department

The Chairperson (Ms Bunting): I welcome, from the Government Actuary's Department (GAD), Paul Butcher, who is an actuary, and Stephen Humphrey, the actuarial director. Thank you for joining us to help us navigate our way through the issue. I invite you to give your presentation, after which it is extremely likely that we will have questions.

Mr Stephen Humphrey (Government Actuary's Department): Good afternoon. Thank you very much for your invite. We will give a few introductions. Paul will do most of the talking today. I am an actuary in the Government's Actuary's Department. I have been involved in providing advice to the Department on personal injury discount rates (PIDR) issues for seven or eight years. I have been involved in previous reviews and in the background of this review.

Mr Paul Butcher (Government Actuary's Department): I am an actuary in the Government Actuary's Department. I am the lead author of the advice to the Department of Justice on the PIDR regulation features that are being discussed today. I will give you a quick introduction, if that is OK. I thought that it would be useful to give a summary of GAD's role, the PIDRs and the key elements of our advice.

There are two main stages of our involvement. First, GAD's role is to assess the evidence available to determine whether the parameters in the legislation remain appropriate and, if not, provide analysis for the Department on what an evidence-based alternative would be. In due course, once a review has started, the Government Actuary's Department will be asked to determine the expected investment return on the assets and a revised rate will be calculated. We are here today to cover that first role, which involved advice to the Department and was formalised in our report dated March 2024. It is also worth noting that the rate is a single rate designed to reflect the investment returns that claimants

could expect on their lump sums, netting off the inflation on their damages, tax and expenses. All of that is done with the target of claimants receiving 100% compensation.

Our advice had five broad conclusions. The first was that the current notional portfolio and the period of investment being 43 years, which will inform the investment returns, remain appropriate.

The second conclusion was that RPI is no longer suitable as an appropriate index for damage inflation, as it is due to be reformed in 2030. There is limited evidence on what damage inflation should be, but it is broadly agreed that it is likely to be between prices and earnings inflation. As a single index is required by legislation, judgement is needed on what index is most suitable. The Department's view was that earnings inflation is more appropriate than prices inflation, and we consider that to be reasonable, as assuming prices inflation would mean that there is an expectation that the majority of claimants would not be 100% compensated.

The third conclusion was that the standard adjustment of 0·75% for tax investment costs is no longer appropriate. While there is some evidence of higher investment costs, the main justification for changing the current adjustment is the higher expected tax costs. That is because the change in the economic climate, through higher interest rates, means that higher investment returns are expected and, therefore, higher tax is applied to those investment returns. We suggested that a range of 1% to 1·75% would be reasonable. The Department's view was that 1·25% is the most appropriate adjustment, and we consider that view to be reasonable.

The fourth conclusion was that the standard adjustment of 0·5% for the further margin remains appropriate.

The final conclusion was that a single rate mechanism, rather than one that varies by term or another factor, remains appropriate.

That provides a brief overview of our role and key areas. We recognise that it is a complex area, so we suggest dealing with each point in turn: for example, our role, the 100% compensation or the five conclusions that we reached. I will pause there to take questions.

The Chairperson (Ms Bunting): Paul, will you confirm the fourth and fifth points again, please? I missed those.

Mr Butcher: The fourth point was around the standard adjustment of 0·5% for the further margin. Our view is that 0·5% remains appropriate.

The final point was around remaining on a single rate or looking to a rate that varies by term or heads of loss or an alternative measure. Our view is that a single discount rate remains appropriate.

The Chairperson (Ms Bunting): Thank you. Do members have any questions? If you are not sure, please ask.

Justin has questions. That is good, because this is not the time for pride. This is the time to get down to making sure that we fully understand the decision in front of us.

Mr McNulty: Thanks, Paul and Stephen. The aim of the relevant legislation is to ensure 100% compensation, no more and no less. I fully support and endorse that principle. How is the 0·5% further margin consistent with the aim of 100% compensation?

Mr Butcher: I will start, and Steve can give additional thoughts. The broad principle of how the assumptions were set is best estimates. That is a 50% likelihood of overcompensation or under-compensation. There is always a range of possible outcomes, and the best estimate is at that level. When the legislation was being established the first time, a further margin was deemed appropriate, and that was to reflect that you want to reduce the possible range of under-compensation. Our advice at the time was that, by moving the margin by 0·5%, we would broadly expect to reduce the probability of under-compensation from 50% to around 30% to 35%. Effectively, it is because of the expectation that 65% to 70% more people are fully compensated but recognising that that is a balanced judgement. Steve, have you anything to add to that?

Mr Humphrey: Only that this adjustment is a common feature in setting PIDRs. It is the only area where the assumption setting does not follow a best-estimate basis. The idea is that you set an overall

rate, through a best estimate, and then this 0·5% adjustment provides claimants or plaintiffs with more money so that they have a better than 50:50 chance of reproducing their damages. The 0·5% adjustment was also common in other jurisdictions of the UK that developed legislation, so it is a common feature.

Mr McNulty: Is it standard to put 0·5% on top of the 0·75% to bring it to 1·25%?

Mr Humphrey: I will pass you back to Paul in a second, but I think that it is useful to break down the further adjustments into two components. There is one that was 0·75% and has been increased to 1·25%, and it relates to tax and expenses. There is a further adjustment of 0·5%, and it is that 0·5% that we described just now. The 0·5% adjustment is to improve the potential for reaching 100%. The other element is for tax and expenses of investments. Paul will give a few comments about that.

Mr Butcher: As I said, our advice was that the 0·75% adjustment for tax and expenses would be too low. Whilst we have seen through the evidence gathered that there are some suggestions of higher investment costs, it is largely being driven by higher tax costs. It is worth noting that previous advice that the Government Actuary's Department gave across all UK jurisdictions was that the current rate would not be appropriate for tax in a high interest rate environment, which is the environment that we find ourselves in now, compared with pre 2022. The expectation behind the modelling is essentially that that higher interest rate environment leads to higher investment returns and that those higher investment returns lead to individuals needing to pay more tax — income tax or capital gains tax — on those investments and that, therefore, the tax adjustment needs to increase accordingly.

Mr McNulty: OK. Thank you.

In its report, the Government Actuary's Department advised that *[Inaudible owing to poor sound quality]* average weekly earnings (AWE) is likely to range between CPI+1.5% and CPI+1.8%. However, expert advice from Oxford Economics, commissioned by the Association of British Insurers (ABI), concluded that, if 50% of losses are price-related and 50% are wage-related, as was assumed by GAD in its 2019 report to the Lord Chancellor in England and Wales, a plaintiff's losses could be expected to increase over time at a rate of around CPI+0·6%. A further GAD report accepts that an earnings-based index would potentially overestimate the inflation experienced in practice. Is it not the case, therefore, that the proposal to adopt the average weekly earnings index, which overstates inflation and would lead to overcompensation, is a reason not to adopt the 0·5% further margin on top of the standard adjustments?

Our insurance premiums in the North are the highest in these islands. The compensation rates by trust per year, averaged over the last five years, are £33·2 million, so there are major ramifications of the decision on this rate. Why are premiums higher here? What is the burden on public bodies as a consequence of the rate being decided at that level?

Mr Butcher: There are a few points there. I will pick up on the point about inflation first. The current regulations refer to RPI. That was previously deemed to be a suitable measure because, at that point, RPI was between CPI and earnings. The 50:50 split was a judgement made at that time. There has not been particularly strong evidence on where damage inflation sits, so it was deemed that, rather than explicitly saying that damage inflation is definitively a 50:50 split between prices and earnings, RPI was the most suitable index for damage inflation.

A feature of our advice is that it is very much within the legislative constraints. The constraints from the legislation were that a single index needed to be selected, and we agreed with the Department's view that AWE is the most appropriate single index available to represent damage inflation. Part of our discussion with the Department was about the fact that there is no ability to cross-subsidise across different features; each feature needs to be set with its own appropriate measure so that — *[Inaudible owing to poor sound quality.]*

The Chairperson (Ms Bunting): We have lost you, Paul.

Mr Humphrey: I think that the Committee lost your audio about five seconds ago.

Mr Butcher: The last thing I was talking about was the fact that, because we have to work within the legislative framework, we discussed a range of options with the Department. One feature that was told to us was that you cannot cross-subsidise across assumptions, so each assumption is set with its own

best estimate — its most appropriate range — and that a further margin was not designed to look at different levels of damage inflation. Therefore, they are separate. That is why we do not assume any possible cross subsidies across features of the discount rate.

Mr Humphrey: I will pick up some of the more general points. There has always been a challenge in obtaining information on the types of damage inflation that plaintiffs and claimants are subject to. As well as the information that the ABI is able to collate, information is provided from the claimant groups. They provide quite a lot of support for the view that large elements of damage inflation are wage-related; care costs and the like are likely to be wage-driven. The evidence spreads across those items. We would certainly feel uncomfortable with a claim damage inflation of prices only. We feel, given the mix of damages that individuals are subject to, that there ought to be a large wage component.

As for the impact on insurance premiums, yes, it is true that this is a contributory factor. We do not have modelling of the precise impacts, so I cannot tell you what a move of 1% or 2% in the PIDR does to insurance premiums, but it is certainly true that it is a key factor. That is recognised in the importance of setting the discount rate and providing advice.

The Chairperson (Ms Bunting): Gents, can I just clarify a couple of things? Last week, some members discussed the impact if the rate were to stay the same. There are a couple of things that we are trying to get our heads around. Some people suggested that we were more likely to stay as close as possible to the 100% mark if the rate did not change. Others have suggested that moving from 0·75% to 1·25% would mean potential overcompensation for claimants. Will you give us your response on that, please, so that we have a greater understanding of those areas?

Mr Humphrey: I will make a few comments and then pass to Paul. One general comment is that future investment returns are not known. They will vary, and they can be assessed only as an estimate. The returns that individuals actually achieve will provide quite a range, with a large variation. In practice, it will depend on the types of damage that the individual has tried to reproduce and how successful they are with their investment returns. I would turn the question around a little: you can never be sure that you are providing 100% compensation. There will always be the risk of under-compensation, and there will always be the risk of overcompensation. In setting the parameters, you are looking to balance those two risks. If there were a lower allowance for tax and expenses, there would be a risk that you under-compensate individuals and do not give them enough money and that they suffer higher rates of taxation and are unable to reproduce their allowance. Paul, do you want to add anything?

Mr Butcher: Yes, just to reiterate the point in our advice that the current position — I am talking about that particular adjustment in tax and expenses of 0·75% — is below what we in GAD consider appropriate. Our view is that the current position is not in line with the principle and, therefore, increases risks in relation to compensation. Our view is that the Department's move to 1·25% is reasonable and is much more comfortably within the range where we consider that that is an appropriate adjustment. As I said, that is largely driven by the expectation of higher interest rates leading to higher tax returns and higher investment returns, which are then just netted off by a tax. Overall, the investment returns should be higher. You just have a larger proportion of tax, whereas, when you are in a very low interest rate environment, because there are small investment returns, it is much more reasonable to expect that most of those investment returns could be covered by tax-free allowances and other tax-management systems. In a higher interest rate environment, it is reasonable to expect that people will pay more income tax and capital gains tax. That is the key driver, in our mind, for the need to increase from 0·75% to 1·25%.

The Chairperson (Ms Bunting): Finally, can I clarify something? Is it you who cannot take into account the implications for insurance, or is it the Department of Justice? Is it both?

Mr Humphrey: We are answering the questions that the Department provides to us, but we will be conscious of the environment in which the rates are being set. We clearly understand our role as helping the Department to set the parameters as best estimates and then the 0·5% further adjustment. If there were a desire to change the balance of under-compensation and overcompensation, that would be something for the legislators, not for GAD, to do. Paul?

Mr Butcher: That is a fair assessment.

Miss Hargey: Thanks very much. I missed the last briefing session on this, so apologies. It talks about an impending review and the regulatory framework, and it said that the forthcoming review may affect the insurance policies. Will the forthcoming review also review the two areas that we are considering as part of this paper today?

The Chairperson (Ms Bunting): Moving from AWE to —

Miss Hargey: Yes. And the one —

The Chairperson (Ms Bunting): Yes. As I understand it, there are essentially two questions. One is the moving to —

Miss Hargey: Average weekly earnings.

The Chairperson (Ms Bunting): — AWE instead of RPI, and the proposal is that the standard adjustment for the impact of taxation would be 0·75% to 1·25%. My understanding is that people were agreed in every other area. In part of the consultation, Deirdre — it is important that the Committee notes this — nearly all the responses came back to say that everybody would prefer to move to CPI+. However, at this point, that is not within the legislative parameters, so the Department has indicated that it will potentially look at that for the next review in five years. This review is due to kick off in July. The Committee's job is to make a recommendation to the House one way or another, but there are two specific questions. The predecessor Committee had asked the Department to take into account the implications, but the Department said that it could not and should not speak on behalf of other Departments. That is why we are a bit stuck; we are perhaps trying to take into account things that we should not. I am not clear whether we are allowed to be mindful of those issues. Somebody has to be mindful of the issues. Nevertheless, our job and everybody's job here is to plump for the option that gets us as close as possible to 100% compensation, no more and no less. That is the key issue.

Miss Hargey: I wanted to ask another question about the letter from the Department that is in our pack. Under the heading "Regulatory Impact", the letter says that an:

> *"assessment of the current methodology for setting the discount rate was conducted"*

but

> *"concluded that it is not possible to quantify the impact on business".*

It also said that the:

> *"forthcoming review may affect the cost of insurance policies purchased by businesses, charities, social economy enterprises".*

Is the Department saying that it cannot quantify the business element solely, or does that apply across all those different sectors that were named in that sentence? Does that mean that it cannot quantify the impact on charities, social economy enterprises or voluntary bodies? I think that we need to seek legal advice about those broader implications and around what we can and cannot consider.

The Chairperson (Ms Bunting): Before we take a decision on any of that, does anybody have any further questions for the actuaries?

Ms Ferguson: I have one question to ask. Throughout the report, it is the claimants versus defendants and there was disagreement. That is where there is a grey area, based on what the government actuaries have said. On the issue of life expectancy, there were claimants pushing for a 30-year investment period. There is mention of a 45-year life expectancy and that it was set at 43 years. In layman's terms, can you explain that? May I give you an example? Let us imagine that I was 82-years-old and I had a serious accident and was seeking compensation. The decisions that are made are based not on an individual but on a collective. On the basis of life expectancy, can you explain how that works? In layman's terms, were I to secure a personal injury investment, how is that looked at to ensure that I get 100% compensation and no less?

Mr Humphrey: I will have a go at that first, and then I will ask Paul to add some comments. I will say a little about how claims work. On your point about the duration, it is important to note that the 43 years

is an average across all areas. If you move that a little, it would not really change the answer. It is not a parameter where, if you move it five years either way, you would get much difference in the answer. It is not that sensitive to the outcome.

In your example of an older individual suffering damage, any compensation provided would be assessed on the life expectancy relating to that individual. They would not be expected to live for 43 years; they might be expected to live for 10 years or whatever is appropriate. The discount rate applied for those 10 years is the same discount rate as applies for a 20-year-old who has suffered an injury. The eventual rate is applied across all cases, regardless of their age.

In looking at this, we have done some work on how investment returns might vary by term and some further underlying work. If you were to try to create complicated arrangements where discount rates changed for the short, the long term or the medium — or some other model — the expectation is that you would be building up something that is very complicated and may not help the legal processes. When jurisdictions have asked, "Would it be better to have more complicated rates?", practitioners in the industry have not been keen on developing that complexity.

Mr Butcher: What the discount rate ultimately determines is a net interest rate — a net investment return rate — that you expect. That is an annual rate. When you are looking at an older claimant — their life expectancy might be only 10 years — that rate is converted into a multiplier. There are tables, called the "Ogden tables", that are produced to help the defence to do that. Therefore, if someone is expected to live 10 years, they will have a shorter reduction in their lump sum for that period of 10 years' investment compared with a much longer-term claimant. That life expectancy is allowed for in the way the discount rate is used rather than being affected by the discount rate, if that makes sense.

Ms Ferguson: Thank you.

The Chairperson (Ms Bunting): Is everybody fine with what we have heard from the actuaries? Nobody has any further questions?

Gentlemen, thank you very much for your time. We really appreciate that; it has been helpful for us. On the basis that we probably do not need anything more, I thank you both for taking the time to explain this to us. It is at moments like these when I am glad that I did linguistics and not mathematics. It is horses for courses. Thank you very much for your assistance as we seek to work our way round the issue.

Mr Humphrey: I hope that we have been helpful. There is always the offer of further assistance, should the Committee need it. Thank you very much.