Government Actuary's Department

Isle of Man - Personal Injury Discount Rate

Executive summary

1.1 This note provides advice from the Government Actuary's Department (GAD) to the Isle of Man (IoM) Treasury Department to inform the review of its Personal Injury Discount Rate (PI discount rate).

1.2 We have been asked to consider at a high level how the PI discount rate that was set in June 2020 may have changed in view of the current market outlook. As such we have focused on changes in our house view of market conditions since our initial advice. We have not considered updates to other tools, such as economic scenario generators which were used in the original 2019 advice and analysis.

1.3 Additionally, as we have not been asked to consider the appropriateness or otherwise of the other assumptions that are used in deriving the PI discount rate, any other assumptions we have used have been consistent with those used at the last rate review.

1.4 Our previous advice was issued on 8 October 2019 ('2019 advice'), this illustrated that it might be appropriate to set a single PI discount rate between CPI-0.75% pa and CPI+0.25% pa, depending on the decision basis and assumptions used.

1.5 Whilst that 2019 advice was under consideration the world was gripped by the COVID-19 pandemic resulting in significant movements in equity markets, gilt yields and credit spreads. We therefore estimated that an equivalent PI discount rate early in 2020 was likely to be 0.25% to 0.50% pa lower (referred to as the 2020 review).

1.6 **On 17 June 2020 a discount rate of CPI-0.25% pa came into operation**, following approval of The Damages (Personal Injury) (Assumed Rate of Return) Order 2020 by Tynwald on 16 June 2020.

1.7 Since 2020 market conditions have continued to move significantly.

- Short-term inflation for the UK has exceeded highs last seen over 30 years ago.
- UK government bond yields increased significantly during 2022 and year to date, offsetting the previous 10 years' worth of falls.

1.8 Applying this to the long-term outlook for markets, nominal returns have increased such **that we estimate that a revised Isle of Man PI discount rate set now would be between 1.0% and 1.25% pa higher than our 2019 advice, that would equate to a PI discount rate of between CPI+0.25% pa and CPI+1.50% pa.**

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1.9 This update has considered GAD's views for changes to long-term inflation expectations and the returns on equities, corporate bonds and government bonds. We have not considered any of the other assumptions underpinning the PI discount rate and our financial analysis has not been to an equivalent depth as that of our 2019 advice. We would be pleased to work with you on a complete review of the PI discount rate in due course. This advice is illustrative only and should be taken in context with the legislative and policy approach taken to setting the rate.

Background

1.10 The PI discount rate influences the size of financial settlement that PI claimants receive. A lower PI discount rate leads to a larger settlement, a higher PI discount rate leads to a smaller settlement.

1.11 The legislation in place prior to the last review for the IoM provided for the PI discount rate to be set with reference to index-linked gilt yields under the principles set out in Wells vs Wells. Based on the last review IoM moved to setting a PI discount rate which reflects the way that claimants invest. **This culminated in the IoM PI discount rate being set at CPI-0.25% pa in June 2020.**

1.12 The PI discount rate can apply across a wide range of claimants – each facing different needs and circumstances. Further, as the costs of PI settlements are met by taxpayers and insurance companies, there is a balance between providing fair compensation to personal injury claimants and not incurring excessive costs.

1.13 A summary of the key factors considered and the chosen assumptions from the 2019 advice and 2020 review were as follows:

- **The financial conditions at the assessment date** – Which influence expected future returns that claimants might earn on their settlement. These were estimated using simulations from economic scenario generators based on financial conditions as at December 2018 and June 2019 (2019 advice), with estimated ranges provided as at March 2020 (2020 review).
- **The claimant characteristics** – In terms of the level and period over which a claimant needs to meet needs from their settlement. We assumed that a representative claimant invests over 43 years and use mortality assumptions from the 2008 ONS UK population projections.
- **The assumed investment portfolio** – In terms of the type of assets that the claimant invests in, which influences the returns they might earn. We assumed a central portfolio allocated as follows:

Asset class	Central portfolio
Lower risk / matching assets	**57.5%**
Cash	10.0%
Gilts	30.0%
Corporate bonds	17.5%
Higher risk / growth assets	**42.5%**
Equities	32.5%
Alternatives	10.0%

- **Tax and expenses** – Including costs such as fund management costs. We assumed 0.75% pa.

- **Inflation for awarded damages** – Which increases the level at which a claimant makes withdrawals from their settlement. We assumed that the damages that a claimant must meet inflated at CPI+1% pa, which is approximately a 50:50 blend of CPI-linked damages and earnings-linked damages.

1.14 Based on these assumptions and the considerations above, as at the last review a single rate was set based on a range of options reflecting the confidence of the claimant being able to meet their needs.

1.15 We have been asked to provide updated analysis based only on updating the financial conditions assumption. To do this we have considered the investment return forecasts available as at 31 March 2023 and compared financial metrics now with those used in our analysis in 2019 and early in 2020. Please note that our 28 April 2020 report contains further details on these assumptions and the PI discount rate methodology.

Economic conditions

1.16 During 2022 and this year to date, most major markets have experienced high inflation that has led to fiscal and monetary policy responses. Equity and bond returns have in turn reacted to high inflation and changing interest rates. Over this period equities had losses of around 10%-20%, bond returns have in general also been negative, with some large losses due to significant yield increases.

1.17 Over the next few years there is uncertainty on the timing and pace of inflation going down, which is impacting expectations for interest rates, bond yields and equity returns. This volatility is expected to have the greatest impact over the next couple of years, but some causes of volatility could become enduring, such as the apparent deglobalisation affecting supply chains, reducing reliance on China, and political instability. Our longer-term inflation and investment return forecasts are less affected by this short-term volatility, but the short-term outlook will still have a bearing on the levels of confidence in our long-term forecasts.

Impact on PI discount rate

1.18 Relative to your last rate review our long-term return forecasts have increased reflecting the significant increase to risk free yields over the last 18 months.

1.19 In periods of high inflation it is typical for yields on fixed-interest government and corporate bonds to increase, due to the price of bonds already in issue falling. This fall in price is a result of the fixed income on bonds becoming less attractive due to inflation eroding its value. This is what happened in 2022, however, those increases to bond yields have become persistent and now stretch out to the long-term. This could be reflecting the views of the market with respect to factors such as an unwinding of the government's quantitative easing and a risk premium in expectation of more volatile economic conditions enduring.

1.20 With a higher yield available on bonds, we then also expect the return on more risky assets such as equities to increase i.e. if you can buy a risk free government bond that now yields more than 4%, you would expect the return on a much risker equity to be considerably higher than 4%.

1.21 Market commentators will often set asset return expectations either relative to inflation or relative to gilt yields.

- Over the last 18 months actual inflation has been high (ie comparing current prices to those 12 months ago), however over the long term we expect inflation to come back down. Our CPI assumption is now around 0.5% higher than our original 2019 analysis.

- Gilt yields have increased significantly at all terms and are around 1.5% to 2.0% higher than our 2019 analysis.

1.22 Asset returns set relative to inflation have therefore not increased by as much as those set relative to gilt yields. GAD's house view starts by setting equity returns relative to inflation, which is why there are only small changes to our returns relative to CPI below. Gilt and corporate bond returns are set relative to gilt yields, so when compared to CPI, they have increased significantly.

1.23 For this interim update we have focused on our house views and judgement to consider whether the range of asset returns are reasonable. We have not used other methods for deriving return assumptions, such as an economic scenario generator as we used in 2019. This house view is based on CPI in the United Kingdom, we have made no allowance for any potential differences with CPI in IoM.

1.24 The table below sets out the change over time in our house views of key economic assumptions. Note these differ to the return assumptions quoted in our previous report as those assumptions were also informed by the use of third party economic scenario generator forecasts.

Table 1: GAD neutral annual investment return assumptions, change over time

Asset class	December 2018	June 2019	March 2023	Change
CPI	1.95%	1.95%	2.40%	+0.45%
Nominal gilts (above CPI)	-0.2%	-0.6%	1.4%	+1.6-2.0%
Investment grade corporate bonds (above CPI)	0.8%	0.3%	2.3%	+1.5-2.0%
Equities (above CPI)	3.6%	3.3%	3.6%	+0.0-0.3%

1.25 Applying the above changes to the assumed central claimant portfolio of assets, we would expect increased returns relative to longer-term inflation assumptions. Our best estimate is that, in the round, this increase is around 1% pa compared to conditions as at December 2018 and 1.25% compared to conditions as at June 2019, plus or minus 0.25% to allow for the additional uncertainty due to undertaking a high level approach to changes in market conditions. **As such, we estimate that a revised Isle of Man PI discount rate set now would be between 1.0% and 1.25% pa higher than our 2019 advice, that would equate to a PI discount rate of between CPI+0.25% pa and CPI+1.50% pa.**

1.26 The size of the increase is subjective and in this review we are informed by our house views for asset returns and the information and judgement of our investment team. There is uncertainty around how quickly inflation may reduce, and its ongoing stability, which will in turn may affect economic conditions and asset return forecasts. We have not included more details on this, or the range of returns possible, but we can provide further details on the confidence of a range of assumptions if required.

1.27 Our analysis has focused on forecasting from 31 March 2023. With the Bank of England base rate increasing from 4.25% to 5.00% since March 2023, and gilt yields having also increased, that could imply a larger increase to the PI discount rate would be appropriate at this point in time. However, the outlook is also volatile.

1.28 We would be pleased to discuss this with the IoM Treasury Department and we would be pleased to provide a regular commentary on the economic outlook and its potential impact on the PI discount rate.

Government Actuary's Department
07 July 2023

Disclaimers

1.29 The analysis outlined above has been carried out in accordance with the applicable Technical Actuarial Standard: TAS 100 issued by the Financial Reporting Council (FRC). The FRC sets technical standards for actuarial work in the UK.

1.30 This report has been prepared for the use of the IoM Treasury and must not be reproduced, distributed or communicated in whole or in part to any other person without GAD's prior written permission.

1.31 Other than the IoM Treasury, no person or third party is entitled to place any reliance on the contents of this report, except to any extent explicitly stated herein, and GAD has no liability to any person or third party for any act or omission, taken either in whole or part on the basis of this report.

1.32 This report must be considered in its entirety, as individual sections, if considered in isolation, may be misleading, and conclusions reached by review of some sections on their own may be incorrect.

1.33 The market views in the report are informed by our analysis for defined benefit pension schemes, use of third party economic modelling data and review of analysis and views from market commentators.