BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

10 May 2017

PRA response to 'The Personal Injury Discount Rate: How it should be set in future'

The Prudential Regulation Authority (PRA) thanks the Ministry of Justice for the opportunity to input into the consultation, 'The Personal Injury Discount Rate: How it should be set in future.' In this submission, the PRA provides its perspective on how the personal injury discount rate ('the discount rate') should be set in future and responds to seven of the specific questions the consultation paper raises.

The PRA is responsible for the prudential regulation and supervision of approximately 600 insurers of all types in the United Kingdom (including general insurers, life insurers, friendly societies, mutuals and the London market). In discharging its powers, the PRA seeks to assess and address risks that the firms it supervises can pose to the stability of the financial system.

The PRA has two primary objectives: a general objective to promote the safety and soundness of the firms it regulates; and an objective specific to insurance firms, to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders. Since 2014, the PRA has also had a secondary objective to facilitate effective competition in the markets for services provided by PRA-authorised firms in carrying on regulated activities. The PRA's policies and supervisory approach are designed with the intention to advance its primary objectives and facilitate its secondary competition objective, in accordance with the Financial Services and Markets Act 2000.

The PRA has an interest in the discount rate given the impact that large changes can have on insurers' best estimate reserves and therefore their stability and that of the general insurance sector as a whole. The PRA would recommend that any uncertainty for insurers be limited as far as possible in any new framework. This would mean that the discount rate is regularly reviewed and, where appropriate, changed, but that any changes are predictable.

The recent change in the discount rate most immediately affected motor insurers, but there may be further effects from the change that are not yet known, i.e. what the impacts are on insurance companies that underwrite other types of liability insurance (e.g. in respect of employers, public and product liability).

The PRA would recommend that the key features of the new framework for setting the discount rate be predictability and transparency. This would mean that the timing of review and likely changes to the discount rate would be known in advance. The intention would be to enable insurance companies to price and reserve appropriately, as well as match and hedge against their unsettled claims. Reducing the uncertainty and enabling insurers to manage the risk of changes to the discount rate would likely reduce the need for firms to include a potentially high risk premium in the price of insurance, and could reduce the cost (or avoid increases in cost) for policyholders.

Such a framework could be achieved through the following measures:

- linking the discount rate to an index created from observable market rates (taking into account the determined overriding principles for setting the rate);
- changing the discount rate at frequent and predictable intervals; and
- review of the framework for setting the discount rate at points specified in the legislation.

A further discussion of these measures is included below in response to specific questions the consultation paper raises.

The PRA has not considered what a fair discount rate for claimants and defendants would be, or what it would be appropriate to assume about the investment behaviour of claimants in respect of lump sum payments. We view this as a wider public policy question that is beyond the PRA's remit. Accordingly, we have not proposed any specific formula for an index or other method for calculation of a discount rate. The impact of the rate change has only been considered on UK insurers. The PRA does not have information relating to EU-based insurers and the impact of those that passport in to the UK.

The PRA is happy to discuss any of the points raised in this response.

Responses to consultation questions

Q19: Do you consider that there are any specific points of methodology that should be mandatory? Please give details and reasons for your choice.

The PRA would prefer that the methodology used to calculate the discount rate be linked to an index based on readily observable market rates. The PRA does not propose to comment on what type of market rates should be used in the calculation of the discount rate, since this will depend on the determined principles for how the rate should be set.

Linking the discount rate to an index would also mean that insurers could predict potential changes to the discount rate with some certainty and therefore reserve for claims and price insurance premiums appropriately.

Q20: Do you agree that the law should be changed so that the discount rate has to be reviewed on occasions specified in legislation rather than leaving the timing of the review to the rate setter? If not, please give reasons.

Yes. The PRA would favour a more transparent and predictable process by which insurance companies, among others, could appropriately plan and factor e.g. into their reserving, any likely change to the discount rate. If the discount rate were to be linked directly to an index as detailed in Q19, the discount rate might not need to be reviewed at all. Instead, the discount rate could be reset at a pre-determined frequency.

If the frequency of changes to the discount rate is specified in the legislation this would help to ensure the predictability and transparency of the new framework. Insurance companies would know when the discount rate is likely to change and be able to reserve and price accordingly.

Q21: Should those occasions be fixed or minimum periods of time? If so, should the fixed or minimum periods be one, three, five, ten or other (please specify) year periods? Please give reasons.

The PRA's preference would be that the occasions on which the discount rate should be reset are fixed. This would make the framework more predictable and ensure that insurance companies and other parties could price and reserve accordingly for any potential rate change.

The PRA would recommend the discount rate be reset with intervals between resets at a maximum of one year. Ideally, the PRA's preference would be for the discount rate to reflect the most up to date information about the relevant market rates used to set it. Therefore, the greater the frequency of resets, the more accurate the discount rate would be. The PRA would suggest that initially the discount rate be reset on a quarterly basis, with reviews of the frequency of resets specified in the legislation.

Having a discount rate that reflects more up to date information of the underlying investment returns would allow insurance companies to match and hedge their liabilities more easily.

In the absence of high frequency resets of the discount rate, the PRA would prefer that the discount rate be reviewed at points specified in the legislation, for example on an annual basis. This would still ensure predictability and transparency in the framework, though the discount rate in this case would not always reflect the most up to date information on the relevant investment returns.

Q23: Do you agree that the rate should be reviewed at intervals determined by the movement of relevant investment returns? If so, should this be in addition to timed intervals or instead of them? What do you think the degree of deviation should trigger the review?

No. The PRA would prefer higher frequency resets of the discount rate rather than reviews triggered by movements of the relevant investment returns. Having triggers would likely detract from the predictability of the framework.

It is worth noting that when rates are negative, small changes have a more material impact on insurers than when rates are positive. This is because the impact of changes in the discount rate on insurers is non-linear.

Q24: Do you agree that there should be a power to set new triggers for when the rate should be reviewed? If not, please give reasons.

Given the PRA's preference would be to not include triggers in the framework at all, there would not need to be a power to set new triggers for when the rate should be reviewed.

However, the PRA would recommend that the framework for setting the discount rate be reviewed at points specified in the legislation to ensure it is working as intended. This could also include a review of the frequency by which the discount rate is reset. The review could take place one or two years after the new framework for setting the discount rate is introduced and after that, every five years.

Q25: Do you consider that there should be transitional provisions when a new rate is commenced? If so, please specify what they should be and give reasons.

No. Regular resets, or indeed review, of the rate and a transparent methodology should, in principle, obviate the need for transitional provisions.

Q33: Please provide any evidence you may have as to the use or expected use of PPOs in the light of the change in the rate and more generally.

It is too early to provide any evidence on the use or expected use of PPOs in light of the change in the discount rate. It is likely that it will be several months before any reliable data on what the impact has been becomes available.