

# NEWSLETTER



by **Ed Tomlinson** Financial Planner

Welcome to the April edition of the IM Asset Management newsletter. Due to popular demand, this edition is a Discount Rate special.

At present we do not know when the Discount Rate may change or even if it will. However, it is clear that any change will have a profound effect on personal injury claims.

The purpose of this newsletter is to provide an in depth commentary on the different aspects of personal injury claims that will be affected and to provide those practicing in this area with a clear understanding of the facts and the consequences of any change.

For those who are not familiar with IM Asset Management we specialise in providing financial planning and investment solutions to clients in receipt of personal injury awards. We provide both pre-settlement financial advice and post-settlement investment planning and management.

## WHAT IS THE DISCOUNT RATE?

The Discount Rate is the rate of return required on a lump sum settlement to provide the income of an equivalent periodical payment for the lifetime of a claimant.

For example, a 70 year old male with a normal life expectancy of 15.5 years and an annual lifetime loss of £10,000 would receive a lump sum of £123,000 (12.3 x £10,000) based on the current Discount Rate of 2.5%.

A lump sum of £123,000 could not, without any growth, provide an annual income of £10,000 for 15.5 years, a total of £155,000. For the lump sum of £123,000 to provide the total income of £155,000 it must grow by the Discount Rate, 2.5% pa.

Age	70
Annual Lifetime Loss	£10,000
Discount Rate	2.50%
Inflation on PPO	0.00%
Multiplier	12.3
Value of Lifetime Loss	£123,000

Year	Age	Lump Sum	Growth	Expenditure	Residual Lump Sum
1	70	£123,000	£3,075	£10,000	£116,075
2	71	£116,075	£2,902	£10,000	£108,977
3	72	£108,977	£2,724	£10,000	£101,701
4	73	£101,701	£2,543	£10,000	£94,244
5	74	£94,244	£2,356	£10,000	£86,600
6	75	£86,600	£2,165	£10,000	£78,765
7	76	£78,765	£1,969	£10,000	£70,734
8	77	£70,734	£1,768	£10,000	£62,502
9	78	£62,502	£1,563	£10,000	£54,065
10	79	£54,065	£1,352	£10,000	£45,417
11	80	£45,417	£1,135	£10,000	£36,552
12	81	£36,552	£914	£10,000	£27,466
13	82	£27,466	£687	£10,000	£18,152
14	83	£18,152	£454	£10,000	£8,606
15	84	£8,606	£215	£10,000	-£1,179

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2.5% is hardly a high rate of return, even in today's low interest rate environments there are bank accounts available that are paying more interest. However these rates do not allow for inflation.

The return of 2.5%, will only meet the needs of a claimant whose income is not increasing. If the claimant's income is to increase then the return must also be increased. If for example RPI is 2.0% then the claimant's lump sum must grow by the Discount Rate plus inflation, 2.5% + 2.0% (a total of 4.5%), to provide an income stream increasing by 2%.

Age	70
Annual Lifetime Loss	£10,000
Discount Rate	4.50%
Inflation on PPO	2.00%
Multiplier	12.3
Value of Lifetime Loss	£123,000

Year	Age	Lump Sum	Growth	Expenditure	Residual Lump Sum
1	70	£123,000	£5,535	£10,000	£118,535
2	71	£118,535	£5,334	£10,200	£113,669
3	72	£113,669	£5,115	£10,404	£108,380
4	73	£108,380	£4,877	£10,612	£102,645
5	74	£102,645	£4,619	£10,824	£96,440
6	75	£96,440	£4,340	£11,041	£89,739
7	76	£89,739	£4,038	£11,262	£82,516
8	77	£82,516	£3,713	£11,487	£74,742
9	78	£74,742	£3,363	£11,717	£66,389
10	79	£66,389	£2,987	£11,951	£57,425
11	80	£57,425	£2,584	£12,190	£47,819
12	81	£47,819	£2,152	£12,434	£37,538
13	82	£37,538	£1,689	£12,682	£26,544
14	83	£26,544	£1,194	£12,936	£14,803
15	84	£14,803	£666	£13,195	£2,274

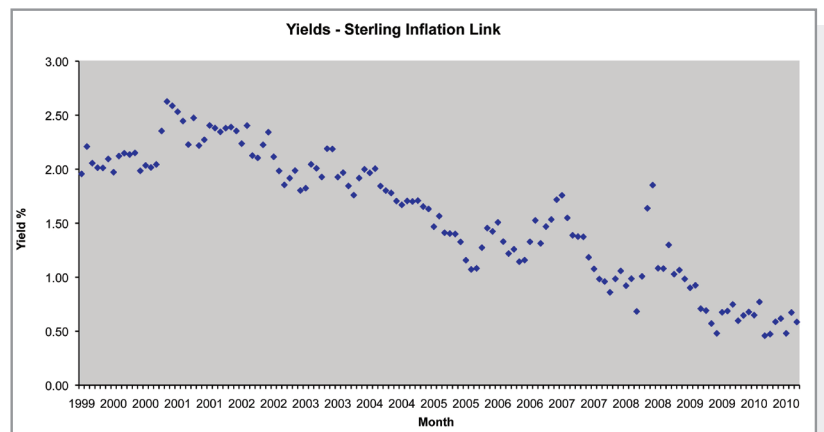
Knowing that RPI is currently 5.3% (April 2012), then a claimant with a lump sum who wants their income to increase by RPI must produce a rate of return of 7.8% (2.5% + 5.3%) net of charges and taxes. It now becomes clear that for a claimant to achieve a return of the Discount Rate is very hard indeed.

## HISTORY OF THE DISCOUNT RATE

In *Wells v Wells* [1999] 1 AC 345, the House of Lords approved the practice of using a Discount Rate based on the gross redemption yield of index linked gilts. The amount arrived at was 3% which was the yield on index linked gilts, when the cases had originally been decided in 1995, less 15% to allow for income tax on a gross return.

Section 1 of the Damages Act 1996 empowered the Lord Chancellor to fix a rate of return for different classes of cases. In June 2001, the Lord Chancellor, exercising his powers under Section 1 of the Damages Act 1996, fixed the Discount Rate at 2.5% for all cases to make it easier to apply. The 2.5% was based on the average gross redemption yield on index linked gilts. For the three years leading up to 8 June 2001, the average gross redemption yield on index linked gilts was 2.46% which after tax at 15% reduced to 2.09% but was rounded up by the Lord Chancellor to the nearest 0.5% to "take account of matters which I consider relevant to the setting of a Discount Rate".

The Discount Rate was linked to index linked gilts as it was considered that a claimant receiving a lump sum should invest in assets that were 'risk free'. However, since 2001 the yield on index linked gilts has only exceeded 2.5% for 3 months. The average yield for the 10 years up to December 2009 has been around 1.6%, whilst the yield over the past 12 months, up to February 2012, has been 0.62%. Rounded up this provides a Discount Rate of 1.0% and rounded down a Discount Rate of 0.5%.



Source: Bloomberg, BSI0Y Index monthly data from 31 December 1999 to 28 February 2011

In November 2010 in a letter from the Treasury solicitor, it was announced that the Lord Chancellor would review the Discount Rate and this would commence shortly. No timescale has been given for the completion of the review.

In the recent case of *Helmut v Simon*, held in the Guernsey Court of Appeal, Jonathan Sumption QC, who presided over the case, reviewed the Discount Rate and the basis of its calculations. The conclusion was to reduce it from a single rate of 2.5% to 0.5% for future recurring non-earnings related heads of loss and to -1.5% for earnings related claims.

## Effect on Settlement Values of a Change in the Discount Rate

The tables below demonstrate how much the lump sum value of lifetime future losses will increase by if the Discount Rate reduces to 0.5% and 1.0%. The difference reduces the shorter the life expectancy however it remains substantial at all ages.

Age	Life Expectancy	Life Multiplier		Difference
		2.50%	0.50%	
10	75.95	33.72	62.79	86%
20	64.87	31.63	54.99	74%
30	54.1	29.05	47	62%
40	43.52	25.79	38.74	50%
50	33.4	21.86	30.44	39%
60	23.97	17.3	22.35	29%
70	15.5	12.3	14.75	20%
80	8.38	7.25	8.13	12%

These losses are only concerned with those that are linked to RPI. The majority of some claimants losses are costs for care and case management which in the UK Courts it has been accepted that if a periodical payment is awarded it should be linked to ASHE 6115.

It is also accepted that earnings inflation has increased at a faster rate than prices inflation. In the Helmut v Simon case the Court heard evidence from Rowland Hogg. The Court found that the difference would be of the Order of 2% and that it was likely that this would persist in the long term, producing a Discount Rate of -1.5% (minus 1.5%).

I don't have access to the multipliers for negative discount rates, however the difference will be of a similar magnitude. If we reduce the Discount Rate by 2%, (from 2.5% to 0.5%), then the future losses, for a 10 year old male with a normal life expectancy, increase by 86%. If we then reduce the Discount Rate by a further 2%, (from 0.5% to -1.5%), the future losses would increase by a similar amount, a further 86%. This is a total increase of 172%.

If your care and case management claim is £1,000,000 using a 2.5% Discount Rate it is likely to be in the order of £2,750,000 using a Discount Rate of -1.5%. Such an increase in the lump sum value of claims would favour lump sum settlements and could see periodical payments become far less common.

Age	Life Expectancy	Life Multiplier		Difference
		2.50%	1.00%	
10	75.95	33.72	52.69	56%
20	64.87	31.63	47.14	49%
30	54.1	29.05	41.19	42%
40	43.52	25.79	34.7	35%
50	33.4	21.86	27.86	27%
60	23.97	17.3	20.89	21%
70	15.5	12.3	14.07	14%
80	8.38	7.25	7.89	9%

Source: Multiplier for pecuniary loss for life (males)

## Effect on Accommodation Claims and Interim Payment Applications

As well as affecting the structure of the settlement, any reduction in the Discount Rate will reduce the magnitude of the Roberts and Johnston claim due to the nature of the calculation being the loss of use of the capital. This could have a significant effect on the overall value of a claim where the majority of the future losses are for accommodation.

Any effect on the accommodation claim will also have an effect on interim payment applications. If the Discount Rate reduces then it is intuitive to reason that if claimants will prefer to have lump sum settlements, then large interim payment applications should become more common.

If the Courts continue to adopt the process set out in Eeles, then large interim payment applications would become harder to obtain. This is because the stage 1 Eeles sum would reduce in value. The stage 1 Eeles sum consists of general damages, past losses and the future accommodation claim, if the Discount Rate reduces, then the general damages and past losses will remain the same however, the Roberts & Johnstone claim will reduce providing an overall lower sum that can be used in interim payment applications.

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