LCP INSIGHT CLARITY ADVICE

# Ogden rate change

MARCH 2017

## *Is the Lord Chancellor adding insult to injury claims?*

The Lord Chancellor's shock decision to slash the discount rate used to calculate personal injury payments (the "Ogden rate"[1]) from +2.5% to -0.75% has hit insurers hard, costing the industry billions of pounds.

The Association of British Insurers has labelled the change a "crazy decision" and will be lobbying hard as part of the government's promised consultation about how the rate should be set in future.

However, as things stand, the (only?) silver lining for insurers may be that at least the methodology for the -0.75% has been made clear:

*"I have taken a simple [3-year] average of yields across all index linked gilts and...have excluded stocks with less than five years to maturity. I am clear that this is the only legally acceptable rate I can set."*
**Liz Truss,**
**Lord Chancellor**

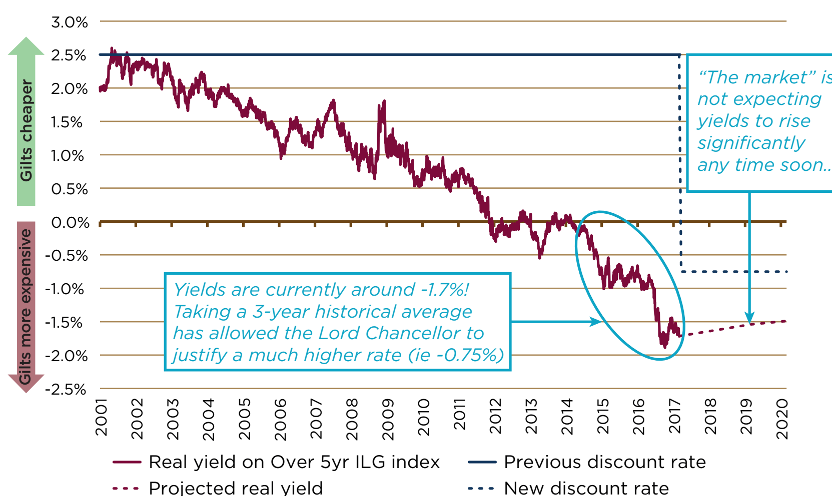
### The future

The future course of the Ogden rate all depends on the outcome of the consultation. However, following 16 years of inertia, it's a fair assumption that the rate may be reviewed more often in future.

But a move to a more frequent review could spell big trouble for insurers because, unless the methodology is changed substantially, the rate is likely to keep going down for some time.

The chart below shows how real yields have moved since the +2.5% discount rate was set in 2001; and how current market pricing implies that yields will move between now and 2020.

Based on current market pricing it seems likely that – if the Lord Chancellor reviews the discount rate again any time soon – the next move is likely to be down (and perhaps significantly so), rather than up.




*Market pricing suggests the next move is likely to be **down** rather than up.*

[1] The Ogden rate represents an assumed investment return (net of inflation) that the claimant might be able to earn on the award.

### Where may the discount rate go next?

Based on market expectations of yields, if the Ogden discount rate was reviewed annually, it would be **-1.25%** in 2018, **-1.5%** in 2019 and **-1.5%** in 2020.

This means that the recent announcement may well represent the thin end of the wedge.

## How can you protect yourself against further bad news?

The Ogden change and forthcoming consultation means that in future there is likely to be a strong link between the price of long dated gilts and the size of payments that insurers need to make to injury claimants.

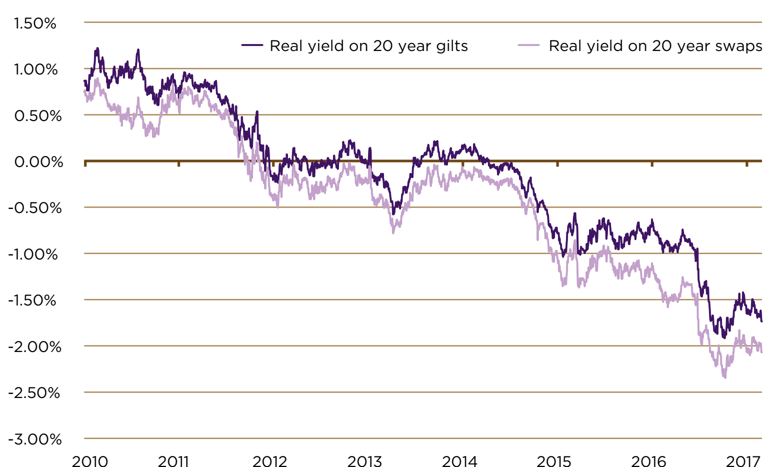
Investing in long-dated index linked gilts would offer some protection against a further hit to your profits. This is because the same conditions that will most likely reduce the Ogden rate (lower real gilt yields) will also increase the value of index-linked gilts.

However, with yields already at low levels the cost of protection is high by historical standards. One pragmatic and effective way to manage this cost, which many of our clients have adopted, is to use a broader range of instruments.

To illustrate this, the chart below shows that the yields on gilts and swaps have historically tracked each other closely. While there are relatively small differences most of the time, there are occasions when the prices of these instruments converge and diverge significantly.

By systematically taking advantage of these price differences and holding the cheapest instrument at any time, investors have historically boosted their returns by about 0.5% pa. In a world of low yields, that makes a huge difference.

A secondary area of impact could be liquidity, as larger lump sums in the short term will increase your cash requirements to an extent. It's worth bearing in mind that some long dated "real" assets (such as infrastructure) can provide some inflation protection but typically don't offer good liquidity.




*In recent years, investors have boosted returns by 0.5% pa by dynamically allocating between gilts and swaps.*

## Contact us

To discuss how we can help you invest to meet the challenge of falling discount rates, please contact John Clements or Charl Cronje.

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