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A CUT ABOVE - THE IMPACT OF A CHANGE IN THE OGDEN RATE

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Richard Paris-Smith of Willis Towers Watson explains how the UK's recent changes to the Ogden discount rate will affect captive insurers.

The UK chancellor has recently announced a significant reduction in the Ogden discount rate, which is used to adjust lump-sum compensation awards to injured parties, to account for future income through investing the pay-out. The cut from 2.5 percent to -0.75 percent was far more dramatic than expected.

With the rate having remained unchanged since 2001, this decision might be viewed as overdue and over-done. Even while the insurance market absorbs this change, and the full impact is as yet uncertain, the position may be set to change again in the near future.

Under considerable industry and media pressure, the government has announced a new six-week consultation to review the process for setting the discount rate. Some reports are indicating that claimants are anticipating that the discount rate will go back up, and many are settling claims at positive discount rates.

In the meantime, the commercial market has been considering the chancellor's original decision. Motor insurers and reinsurers are likely to be most affected, but writers of other liability lines will also be affected. Exposed companies will consider:

- Making a one-off provision increase for unsettled claims relating to business already underwritten, affecting their results for the year
- Assuming higher claims costs when reserving for future business, and therefore adjust their premium pricing models accordingly

This decision seems likely to counter the positive effect on claims costs of recent whiplash reforms, and to result in material rate increases in the motor sector. Ahead of the announcement, some of the UK's largest motor insurers had already stated that they had provisioned for an expected reduction in the Ogden rate to somewhere between 1.5 percent and 0 percent. With the rate actually falling to -0.75 percent, insurers may have to further strengthen their provisions.

Some sources predict significant hikes in motor premiums, with one off reserve increases of more than £5 billion. Even so, as most large insurers have portfolios that are well diversified by geography and business line, the impact of this change on overall earnings and capitalisation is likely to be limited.

Captive insurers also need to understand the impact of this measure on their reserves and future business models.

The exposure of many captives is limited through policy limits or reinsurance protection to both 'any one claim' and 'aggregate' limits. To this extent, the effect on captive reserves may be to push certain individual claims up to their claim limit, and in so doing, push the aggregate claims up to (or towards) the relevant aggregate limit.

Captives may find that the claims most likely to be affected are life-changing injuries and will be relatively few. These may already have breached their per-claim limit, and therefore not lead to any deterioration in the captive's results.

Because of this, the impact on existing captive reserves and the provisioning for future claims may be limited. If a captive continues to write the same limits, it is logical to conclude that the number of claims approaching the limit, or the probability that aggregate limits will be breached, may increase – but not to the extent suffered by the commercial market with its larger and more open-ended exposures.

Nevertheless, the impact should be examined based on each captive's programme, with an accompanying review of current reserves and pricing for the captive policy.

For captive owners, the dynamics around retained and externally insured risk may change as higher projections of future claims performance lead to increased 'ground-up' premiums, and a change in the levels and terms at which commercial insurers and reinsurers are willing to offer cover in excess of captive retentions.

As liability market prices increase as a result of this development, the price for captive policies dealing with these risks will also increase.

However, arguably, the merits of a self-insured captive approach could actually be enhanced, as parent organisations deal with pressures to purchase adequate policy limits at increased rates. And if captive balance sheets hold their own following the Ogden decision, they should remain well placed to assist their parent companies to deal with this risk.

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