LCP INSIGHT CLARITY ADVICE

Investing to back PPOs

How can you manage the long-term investment risks better?

AUGUST 2014

Periodic Payment Orders (PPOs) are now commonly used to settle the most serious personal injury claims in the UK. This part of the market is growing rapidly – starting from virtually nothing ten years ago, PPOs now represent around 10% to 15% of motor insurance liabilities for many insurers. This proportion is expected to increase markedly, perhaps trebling or more, over time.

PPOs have grown rapidly – from virtually nothing 10 years ago.

This growth is pushing general insurers into unfamiliar territory. PPO compensation payments are paid at regular intervals, rather than as a single lump sum. These payments continue until the claimant dies, which introduces significant longevity risk, particularly as claimants are often young victims of motor accidents and could live for another 50 years or more.

The shape of the projected PPO cashflows is likely to be very different between insurers, depending on a number of factors such as their exposure profile, the assumptions and methodology used, their propensity for settling large claims as PPOs and their reinsurance structure.

Investing to back PPO liabilities in a precise way is difficult. In addition, it is not yet clear which (if any) assets will be suitable if companies want to take advantage of the Solvency II matching adjustment. To add to the challenge, payments are inflation-linked, typically defined using the Annual Survey of Hourly Earnings (ASHE), which is a measure of care worker earnings. This is not a mainstream “investible” measure of inflation, such as the Retail Prices Index (RPI).

The good news for general insurers is that these “new” challenges – long-dated liabilities, longevity risk and inflation mismatches – have been the bread and butter of pension scheme investing for decades. There is a wealth of lessons that can be learned and applied easily, to enable general insurers to invest effectively.

These “new” challenges have been the basics of pension scheme investing for decades.

In this note, we summarise **three easy steps** that general insurers can take to make a real difference.

Our simple, real-time models will enable you to understand quickly how PPOs impact your investment risk exposure and how this can be managed by taking different investment decisions.

STEP 1

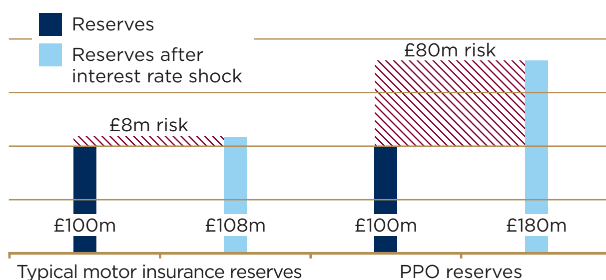
Don't bury your head in the sand – modest amounts of PPOs can represent large risks

Long-dated liabilities are risky. Therefore, even a seemingly modest amount of PPOs in £ terms can represent a large part of your risk exposure, as it punches so far above its weight in terms of risk. This problem will only get bigger, so it is vital that you tackle these risks now.

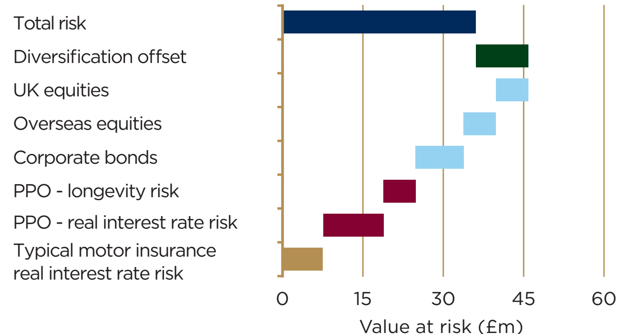
Pension schemes that have ignored the risks of managing long-dated liabilities have done so at their peril. Over the last 10 years, many pension schemes have had their fingers burned and now recognise that managing the interest rate and inflation risk of long-dated liabilities is absolutely crucial. To illustrate the risks, let's consider an insurer with £100m of typical motor insurance reserves (duration 4 years) versus £100m of PPO reserves (duration 40 years).

What would happen if the long term interest rates used to value these liabilities were to fall by 2%, as was the case in 2010/2011 during the Eurozone crisis? In this scenario, the £100m of typical motor insurance reserves would increase by around 8%, or £8m. However, the £100m of PPO reserves would increase by a staggering 80%, or £80m! Put simply, liabilities that are ten times as long are ten times as risky. In our experience, general insurers are just beginning to take action. In a recent Institute and Faculty of Actuaries survey, representing over 90% of the UK motor insurance PRA-regulated market, only 3 out of 14 respondents confirmed that they were actively looking at ways to manage the risks introduced as a result of PPOs. Many others recognised this as an issue, but were still considering which steps to take.

Impact of 2% fall in interest rates



How your risk exposure is broken down



STEP 2

Doing something is better than doing nothing – a pragmatic course of action

As PPO payments typically increase in line with the ASHE index, there are no investment products available to match them precisely (for example, the government doesn't issue "ASHE-linked" bonds). However, rather than simply labelling PPOs as "unmatchable", a better course of action is to consider the tools at your disposal and do something pragmatic.

This is another lesson that pension schemes have learned. Schemes typically have complex liability structures, comprising different inflation measures (eg RPI and CPI) with various caps and collars on pension payments. When faced with these complicated liability structures, pension schemes often manage the risks using simple investments, such as "plain vanilla" RPI-linked government bonds, as it isn't practical to use more complex alternatives. As PPOs represent a large and growing part of your risk exposure, we believe it is normally sensible to back them with low-risk bond-like assets that target the risks of PPOs as effectively as possible, rather than with riskier growth assets such as equities or infrastructure. The assets held should offer a direct link to inflation. Whilst RPI and ASHE may differ significantly over short periods, if RPI is consistently high over the next 40 years, it is reasonable to assume that the increases in care home workers' pay are more likely than not to be relatively high too.

Another challenge is that it is difficult to manage longevity risk closely. Many pension schemes tackle this issue by simply aiming for higher investment returns than they would otherwise, to give them a buffer to cover the potential cost of life expectancy increasing. This logic also applies to general insurers – if you could achieve 0.5% per annum above RPI on the assets held to back PPOs then you would have some comfort margin, in case claimants live longer than you expect.

STEP 3

Be dynamic – by holding the most cost-effective investment

Whilst long-dated RPI-linked government bonds offer a reasonable match for PPOs, they are currently very expensive by historical standards. We can help you to achieve a similar level of matching to holding gilts, but in a more cost-efficient way.

Pension schemes have been facing the problem of gilts being expensive for some time now. As a result they have been proactive in pushing the investment industry to innovate, prompting the development of new techniques to reduce the cost of managing risk in a low governance way.

One positive market development has been the innovation of "Dynamic Liability Driven Investment" funds. These funds invest only in low-risk bond-like assets such as UK government bonds and collateralised swaps. They have a very long duration (up to 60 years and sometimes even longer), which is a good match for PPOs.

Importantly, we believe these funds have the potential to generate returns of 0.5% per annum above RPI in a risk-controlled way. This allows investors to reduce the cost of hedging their long-dated liabilities. They do this by switching between government bonds and swaps in a systematic way. The amount invested in either bonds or swaps will change dynamically, depending on which is cheaper at any given time.

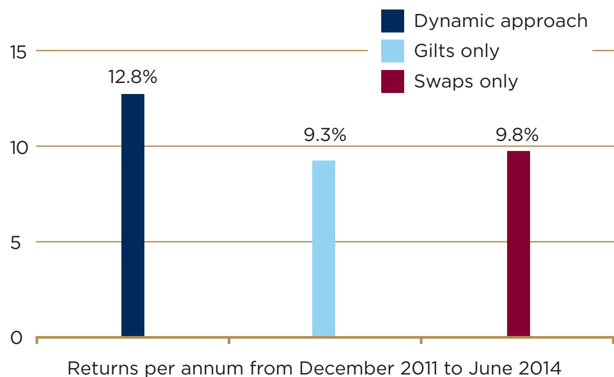
The potential upside to you is material - adding 0.5% per annum to returns represents 20% over the life of a 40 year PPO liability.

Crucially, implementing this approach is straightforward, via low-governance and low-risk vehicles. 10 years ago, using derivatives such as swaps was onerous and generally treated with suspicion by pension schemes. Today, using swaps and other derivatives is common practice, with a large and increasing proportion of pension schemes being comfortable to do so.

We can help you take a few simple steps to give you comfort that you have a robust investment strategy and that your PPO risks are being managed as efficiently as possible.

Long-dated index-linked gilt yields are low by historical standards

A dynamic approach has significantly reduced the cost of hedging, in a low-risk way



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Contact us

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