

Capping: Some examples and complications

Newsletter
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Synopsis:

- To illustrate by example the impact of capping on a loss of income claim under the *Sweatman* and *Jonosky* methodologies.
- To illustrate by example the complications posed when:
 - Capping lump sum benefits;
 - A gain arises in a year.

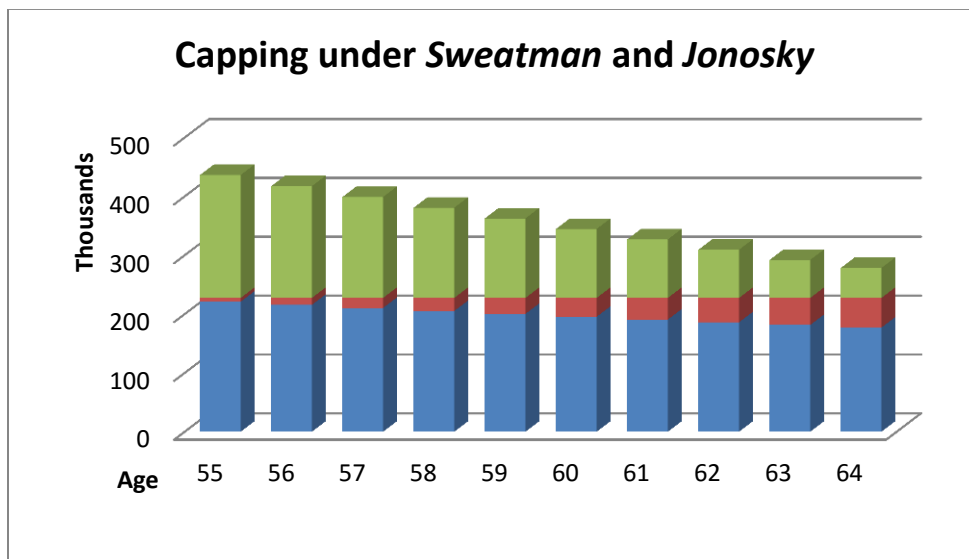
1. *Sweatman* vs. *Jonosky*

Annual losses must be capped for claims that are subject to the *Road Accident Fund Amendment Act*. The two main actuarial methods used to date have been based on the rulings in *Sweatman vs. RAF* and *Jonosky vs. RAF*. The *Sweatman* ruling was recently confirmed in the *Supreme Court of Appeal*.

The following simple example illustrates the impact of capping based on the two methodologies:

Example: Loss of income		Accident date:	2015
		Age at accident:	55
		Earnings before accident:	R600 000 pa
		Earnings after accident:	Unemployable

The graph below illustrates the annual losses, for the 10-year period up to retirement (no pension benefits are assumed):



Key points				
	Jonosky loss:		R1.98m	(56% of uncapped)
	Sweatman loss:		R2.27m	(64% of uncapped)
	Uncapped loss:		R3.55m	(100%)


- The *Sweatman* method typically produces a higher loss than the *Jonosky* method, although not always.
- The *Sweatman* ruling provides only a basic framework for capping.
- Careful thought must be applied to aspects such as collateral benefits, gains vs. losses and lump sum benefits. This is not explicitly addressed in the ruling.

2. Lump Sum Benefits

Lump Sum Benefits are often payable, for instance when a Government Employee retires from the Government Employees Pension Fund (GEPF). The GEPF explicitly allows for a lump sum **and** a regular pension that becomes payable at retirement.

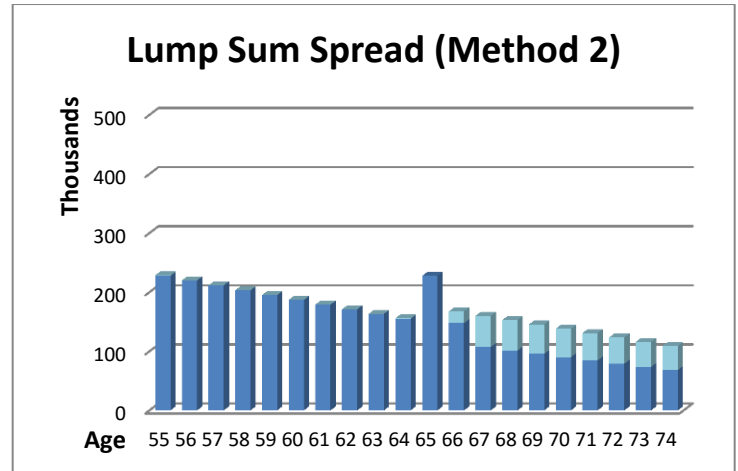
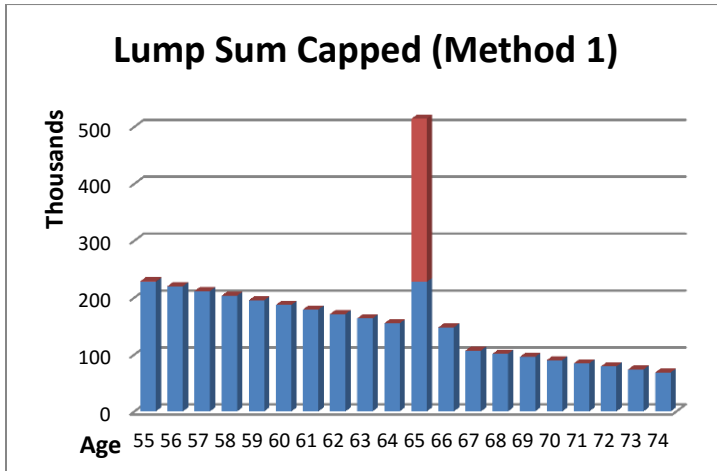
For many GEPF cases, the lump sum received in the year of retirement exceeds the Cap, although the losses in other years are typically below the Cap. Two possible approaches are illustrated using the example below, using the general *Sweatman* methodology:

- Cap the lump sum in the year of receipt (*Method 1*).
- Spread the lump sum over the lifetime of the claimant, essentially treating it as a notional pension (*Method 2*).

Example:		<i>Accident date:</i>	2015
<i>Loss of income</i>		<i>Age at accident:</i>	55
		<i>Earnings before accident:</i>	R300 000 pa
		<i>Earnings after accident:</i>	Unemployable¹

¹ Government workers typically qualify for paid sick leave and pension benefits on becoming unemployable. In practice this should be taken into account, but has been ignored in the example for the sake of simplicity.

The graphs below illustrate the annual losses applying the two methods (considering the 10 year period before and the 10-year period after retirement²).



Key points

Method 1 (Loss): R3.53m (92% of loss using Method 2)

Method 2 (Loss): R3.82m (100%)

- The **RED** bar is being capped.
- The **BLUE** and **LIGHT BLUE** bars are below the Cap and the latter represents the lump sum that has been spread.
- Method 1 is based on a strict application of the Cap, and does not take into consideration the nature of the lump sum.
- Method 2 is based on the assumption that the lump sum is intended to fund the Claimant’s retirement (i.e. it is converted to an equivalent lifetime pension).
- Most other pension funds explicitly allow for a pension only, but allow members to take part of the pension as a lump sum. These lump sums depend on member behavior and are therefore typically not capped in actuarial calculations.
- Method 2 appears to be more equitable, is in line with the treatment of other types of pension funds and takes into account the intention behind the pension lump sum.

3. Gains

It is not unusual for a claim to have a profile of both annual losses and annual gains. Legislation clearly specifies that losses must be capped, but is silent regarding years during which a gain arises. Two possible approaches are illustrated using the example below, using the general *Sweatman* methodology:

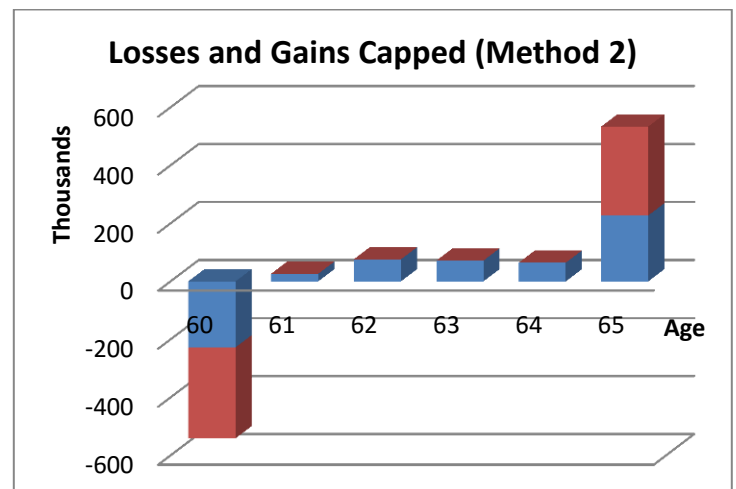
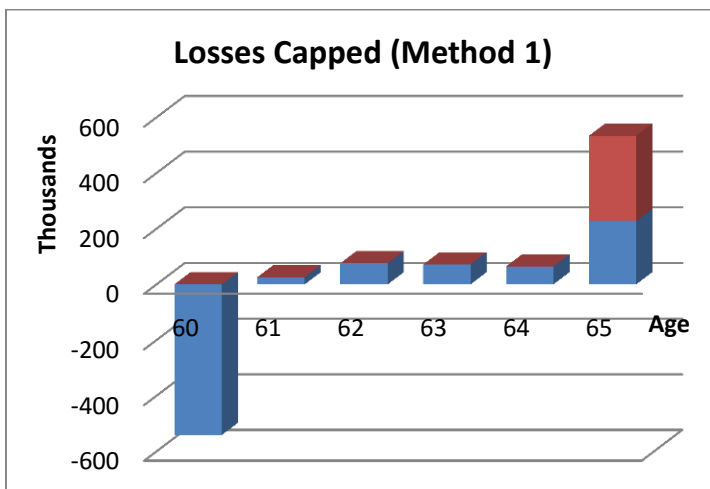
² Theoretically the projection stretches further than 10 years following retirement, but the losses become negligible and it does not detract from the illustration.

- Cap only losses (*Method 1*).
- Cap both losses and gains equivalently (*Method 2*).

Example: <i>Loss of income</i>		<i>Accident date:</i>	2015
		<i>Age at accident:</i>	55
		<i>Before accident:</i>	R500 000 pa
		Retire @ 65	
		<i>After accident:</i>	R500 000 pa
		Retire @ 60	

In the example the Claimant is a government employee, was able to return to her pre-accident position, but will now have to retire 5 years early. She will therefore receive a post-accident retirement lump sum at age 60 (resulting in a gain) and would have received a pre-accident retirement lump sum at age 65 (resulting in a loss).

The graphs below illustrate the annual gains and losses (only the period from ages 60 to 65 is considered, the rest of the years result in negligible losses):



Key points

Method 1 (Loss): R135 000 (31% of loss using Method 2)

Method 2 (Loss): R441 000 (100%)

- The **RED** bars are capped, the **BLUE** bars are not capped or below the Cap.
- Under Method 1, the large uncapped gain at age 60, reduces the capped losses in subsequent years and results in a significantly lower loss.
- Under Method 2, losses and gains are capped equivalently and results in a more realistic and equitable loss.
- Alternative approaches are also possible to deal with this issue e.g. spreading the lump sums (per previous section) or directly offsetting the gain at age 60 with the loss at age 65. These alternatives would produce losses similar to Method 2.

4. Other Considerations

The various collateral benefits such as State Welfare Benefits, Workmen's Compensation Benefits or Accelerated Inheritance need to be carefully considered in relation to capping.

Loss of support calculations also have further considerations in relation to capping, that are not apparent at first glance.

These topics will be covered in a subsequent Information Circular on capping.

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