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Justice Committee

Pre-legislative scrutiny: draft personal injury discount rate clause

Third Report of Session 2017–19

Report, together with formal minutes relating to the report

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Justice Committee

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Summary

When the Government published Command Paper 9500, *The Personal Injury Discount Rate: How it should be set in future: Draft Legislation*, on 7 September 2017, the Secretary of State asked us to undertake pre-legislative scrutiny of the draft clause contained in the paper. We agreed to do so, taking written and oral evidence, and this Report contains our views on the merits of the draft legislation and the evidence and policy objectives underlying it.

The Government proposes to maintain the principle that claimants should receive 100% compensation for losses they incur. It proposes that the discount rate applicable to lump sum damages invested by claimants should no longer be set with reference to returns from Index Linked Government Securities. Instead the draft legislation provides that the discount rate should be set on the assumption that claimants will invest lump sums in "low risk" investments, and having regard to actual investments made by claimants.

In Chapter 3 of our Report we welcome the Government's commitment to the principle of full compensation for claimants, but recommend that it clarifies what it means by this, given that a lump sum award will nearly always either under- or over-compensate claimants (paragraph 24). We say that it may be reasonable to change the assumptions on which the discount rate is calculated if they are no longer representative of "real world" behaviour, but we recommend that clear and unambiguous evidence should be gathered about the way claimants invest their lump sum damages before legislation changes the basis on which the discount rate is calculated; and that if the rate is to take account of investment behaviour, a mechanism must be established to keep those responsible for setting the rate informed about that behaviour (paragraph 53).

Chapter 4 of our Report considers evidence on the balance of costs and benefits likely to be produced by the system of setting the discount rate under the draft legislation, including impacts on social equity, care costs, vulnerable groups and claimants, motor insurance premiums and clinical negligence costs. We consider that the Government should ensure adequate safeguards to prevent significant under-compensation of the most vulnerable claimants (paragraph 88). We also recommend that the Government report each time it reviews the discount rate on the impact of changes in the discount rate on motor insurance premiums to inform setting of the rate in future (paragraph 94).

In Chapter 5 of our Report we consider the process proposed by the Government for setting the discount rate. The Lord Chancellor will set the rate, advised on the first review by the Government Actuary and thereafter by an expert panel. We recommend that the panel should advise on the first review; we also recommend that if the Lord Chancellor chooses not to follow the panel's advice when setting the rate that information should be made public, along with his or her reasons for so doing (paragraph 107). We also recommend that the legislation should require the expert panel and the Lord Chancellor expressly to consider whether to set different discount rates for different periods of loss or different heads of damage (paragraph 125).

Chapter 6 of our Report summarises the changes which we consider should be made to the draft clause to reflect our recommendations before it is introduced to Parliament as

part of a Bill. Other recommendations made in our Report are aimed at improving the operation of the new mechanism for setting the discount rate, but do not in our view necessitate changes to the draft legislation.

1 Introduction

The personal injury discount rate

The PIDR is a figure used to calculate how much defendants should pay claimants in cases of life-changing injury. Compensation in personal injury claims is intended to put the claimant in the position they would have been had they not suffered injury. In respect of future losses (e.g. lost earnings; cost of treatment or care), a lump sum or **Periodical Payment Order (PPO)**, (explained in Chapter 3) or both, may be made.

A claimant is assumed to invest a lump sum and receive a return (of interest and capital), which they can then use for their future needs. The lump sum takes into account the return on investment.

The discount rate reflects the likely investment return. If the discount rate is too high, the value of the return will not keep up with inflation; if too low, the claimant could be overcompensated due to the interest received. Ideally, by the time the claimant meets an expense in the future, they will have right amount available to pay for it.

> Under the old rate (2.5%), a defendant would have needed to pay out £976 to a claimant to cover a £1,000 loss in say, a year's time. The claimant was expected to earn 2.5% interest a year on a lump sum payment of £976, which would yield £1,000. [£976 + (£976*0.025) = £1000]
>
> Under the new -0.75% rate, the defendant must pay £1008 to a claimant to cover a £1000 future loss in compensation. [£1008 + (£1,008 x -0.0075) = £1000][1]

1. On 7 September 2017, the Secretary of State for Justice, Rt Hon David Lidington MP, made a Written Statement to the House of Commons[2] accompanying publication of a Command Paper entitled *The Personal Injury Discount Rate: How it should be set in future: Draft Legislation*.[3] This Paper contained a draft clause which, if enacted, would give effect to the Government's proposed new mechanism for setting the personal injury discount rate.[4]

2. It contains three main proposals for change to the current system for setting the discount rate, to be effected by legislation. Those proposals are that the discount rate would be:

- set by reference to expected rates of return on a "low risk" diversified portfolio of investments (and having regard to actual investments made and returns available), rather than very low risk investments (with no regard to actual investment) as at present;
- reviewed within 90 days after the legislation comes into force and, thereafter, at least every three years; and

1 Example based on an article in *The Daily Telegraph*, Insurers to save millions, 17 September 2017
2 HC Deb, 7 September 2017, col 13WS
3 MoJ, The Personal Injury Discount Rate: How it should be set in future: Draft Legislation, Cm 9500, September 2017
4 See box on page 5 for an explanation of the discount rate.

- set by the Lord Chancellor following consultation with an expert panel (other than on the initial review which would be by the Lord Chancellor with advice from the Government Actuary and HM Treasury).[5]

3. When making the announcement about the Government's current proposals, the Secretary of State indicated that "based upon the evidence currently available and using illustrative assumptions, …. if a single rate were set today under the proposals the real rate might fall "within the range of 0% to 1%".[6] The discount rate has been set at -0.75% in real terms since February 2017.

4. A summary of the proposed changes to the current system is given in the table below.

Status quo	New Proposals
Lord Chancellor sets rate after consulting Government Actuary and Treasury	Lord Chancellor sets rate after consulting expert panel and Treasury
No fixed review of discount rate	Discount rate set at least every 3 years
Assumptions about investment of lump sums derive from case law (*Wells v Wells*)	Assumptions derive from legislation
Rate should be set on the assumption that lump sums are placed in very low risk investments, by reference to yields on Index Linked Government Securities	Rate should be set on the assumption that the recipient of the relevant damages invests the relevant damages in a diversified portfolio of investments; using an approach that involves (1) more risk than a very low level of risk, but (2) less risk than would ordinarily be accepted by a prudent and properly advised individual investor who has different financial aims

5. When he published the Command Paper, the Lord Chancellor wrote to our Chair, inviting us to undertake pre-legislative scrutiny of the draft clause and report by the end of November 2017. He expressed the hope that

> this scrutiny will help ensure that the provisions are technically effective and provide assurance to interested parties that the Government is committed to ensuring that compensation remains full, fair and reasonable in the light of changing investment conditions.[7]

6. At our first meeting of the new Parliament, on 13 September 2017, we agreed to undertake the pre-legislative inquiry requested by the Government. We announced the inquiry the following day and asked for written evidence by 13 October in response to specific questions, as follows:

- The Government's stated objective is to "reflect actual claimant investment behaviour and ensure claimants are compensated in full neither more or less". Does the text of the draft legislation achieve this objective, and could it be better achieved by other legislative or non-legislative means?

5 HC Deb, 7 September 2017, col 13WS
6 HC Deb, 7 September 2017, col 13WS
7 Letter dated 7 September 2017 from the Secretary of State to the Chair.

- Will the proposed legislation result in a fairer framework for (a) claimants, especially those for whom any risk would be ill-advised (b) defendants and (c) wider society? Is the move from "very low risk" to "low risk" appropriate, and are these terms clear enough?

- Should the way personal injury claimants generally choose to invest lump sum damages influence how damages are calculated for all such claimants?

- How robust is the Government's analysis of the proposal and of its impact on (i) claimants (ii) insurance companies and (iii) the NHS? (Impact assessment). Who will be the main losers from the proposal and how much will they lose by?

- How likely is it that changing the methodology for calculating the discount rate will result in a reduction of insurance premiums? Is the Government right to assume that insurance companies will pass on savings?

- Who should be on the expert panel, and who should make the final decision? Are there any circumstances where the Lord Chancellor should not follow the advice of the independent expert panel?

- Would it be better to review the rate more, or less, frequently than proposed (every three years)?

- Does the proposal allow different discount rates to be set for different types of loss? What would be the advantages and disadvantages of this approach?

7. We received 41 submissions which we accepted as evidence to this inquiry; and we held one evidence session, on 1 November 2017, when we heard from:

- Richard Cropper, Personal Financial Planning (PFP) Ltd;

- Brett Dixon, President, Association of Personal Injury Lawyers (APIL);

- Professor Victoria Wass;

- Martin White, Institute and Faculty of Actuaries;

- Huw Evans, Director General, Association of British Insurers (ABI);

- Emma Hallinan, Director of Claims and Legal, Medical Protection Society;[8]

- David Johnson, Forum of Insurance Lawyers; and

- Lord Keen of Elie QC, Ministry of Justice Spokesperson in the House of Lords.

8. In addition, the Government made available to us copies of responses to the proposals in Cm 9500 which they had received from stakeholders. We are grateful to all those who have assisted us with this inquiry.

8 The Medical Protection Society ("MPS") is a protection organisation for doctors, dentists and healthcare professionals. Membership provides access to expert advice and support together with the right to request indemnity for complaints or claims arising from professional practice.

2 Background

9. The Damages Act 1996[9] gives the Lord Chancellor power to set the discount rate, but no methodology is prescribed. That derives from case law: in particular, the 1998 House of Lords case of *Wells v Wells*.[10] Since 2001 (in England and Wales; 2002 in Scotland) the rate has been set on the hypothetical assumption that lump sums are placed in very low risk investments, by reference to yields on Index Linked Government Securities (ILGS).[11]

10. In 2001, the Government set the discount rate at 2.5% in real terms. Despite yields falling sharply since that time, the Government did not change the discount rate until February 2017, when the then Lord Chancellor, Rt Hon Elizabeth Truss MP, moved it to -0.75%, based on a three-year average of real yields on ILGS.[12]

11. A negative discount rate is counter-intuitive because it implies that a sum paid now will be worth less in the future. It is usually the other way around: people would ordinarily expect to earn a positive return on the sum received.

12. The Government recognised that the change would cause a significant increase in compensation awards, which could lead in turn to increases in insurance premiums and also have implications for costs to the NHS arising from clinical negligence claims. However, the then Lord Chancellor said that she was "clear that this is the only legally acceptable rate I can set".[13] The insurance industry expressed dissatisfaction with the sharp reduction in the discount rate, while it was welcomed as being long overdue by those representing claimants.

9 Damages Act 1996

10 *Wells v Wells* [1998] UKHL 27; [1999] AC 345

11 Cm 9500, draft Explanatory Notes. ILGS are 'gilts' issued by the UK government. They have their principal and coupon (interest) payments adjusted according to the official government Retail Price Index (RPI).

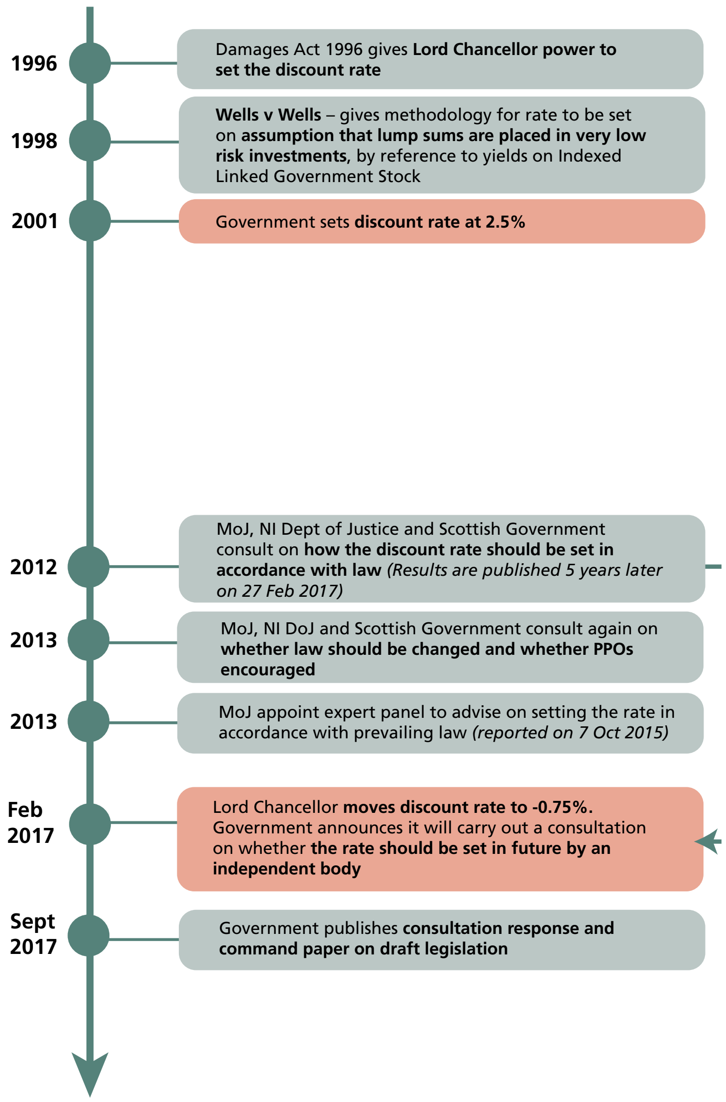
12 HC Deb, 27 February 2017, col 2WS

13 MoJ, 'New discount rate for personal injury claims announced', accessed 28 November 2017

Government consultations

13. In recent years, there have been a number of Government consultations about the discount rate, as detailed below:

Consultation timeline



14. In 2012, the Ministry of Justice, Northern Ireland Department of Justice and Scottish Government consulted on how the discount rate should be set in accordance with existing law.[14] In 2013, the Governments again consulted, this time on whether the law should be changed and whether periodical payment orders should be encouraged.[15] The results of both consultations, published in 2017, showed there was little consensus.[16]

14 Damages Act 1996: The Discount Rate: How should it be set? Consultation Paper CP12/2012, MoJ , DoJNI and Scottish Govt, August 2012

15 Damages Act 1996: The Discount Rate: Review of the Legal Framework Consultation Paper CP3/2013, MoJ, DoJNI and Scottish Govt, February 2013

16 Damages Act 1996: The Discount Rate: How should it be set?, MoJ, Feb 2017 and Damages Act 1996: The Discount Rate: Review of the Legal Framework, MoJ, March 2017

15. Around 2013, the then Lord Chancellor appointed an expert panel to advise on setting the rate in accordance with the prevailing law. It reported on 7 October 2015 that a rate assuming "risk-free" investment should be set with reference to ILGS; or that a "very low risk" portfolio might be appropriate, with up to 25% (50% said the minority) invested in non-risk free assets.[17] The experts agreed that:

> Actuarial practice is supportive of the use of risk free discount rates in the context of quantifying an award of damages. ILGS provide a measure of these risk-free rates.[18]

16. The Government's revision of the rate to -0.75% in 2017 was followed shortly afterwards by a consultation on—

- the principles governing the setting of the rate, including what investment returns should be taken into account and the relevance of PPOs;
- how often the rate should be set; and
- who should set the rate.

17. In Cm.9500 the Government noted 47 of 135 responses indicated there was currently "over-compensation". Opinion was divided on whether claimants should be considered either to have a "very low risk" appetite or a higher, but still "low", risk appetite. As to PPOs: "A substantial majority considered that the current law relating to PPOs was satisfactory, and there was very little enthusiasm for changes to create either a presumption or a requirement in favour of PPOs".[19]

17 Cox, Cropper, Gunn and Pollock, Discount rates: A report for the Ministry of Justice, October 2015, paras 6.6, 6.11 and 6.12. Further questions were subsequently put by the Ministry and answered.

18 *Ibid*, para 6.4

19 MoJ, The Personal Injury Discount Rate: How it should be set in future [Consultation response], September 2017, pp 5, 6 and 8

3 Achieving "full compensation" for claimants

The draft clause includes, in proposed new Schedule A1 to the Damages Act 1996, paragraph 4, which requires the Lord Chancellor to:

- make various assumptions (most notably that a recipient of damages would be properly advised about their investment, and would invest in a diversified portfolio using an approach involving more than "very low risk" but less risk than an ordinary individual investor) and
- have regard to actual investments made by claimants.

This results from the Government's objective that the discount rate continues to "support a 100% compensation rule so that claimants receive full compensation … neither more nor less",[20] and consequent proposals that

- the rate be set "by reference to expected rates of return on a low risk diversified portfolio of investments rather than very low risk investments as at present"; and
- "the actual investment practices of claimants and the investments available to them should be considered."[21]

Government's objective of "full compensation" for claimants

18. The Government's objective is not to disturb the longstanding legal principle that "claimants should be compensated in full for the losses they have suffered because of the injury caused by the defendant". It says:

> The objective of applying a discount rate will therefore continue to be to support a 100% compensation rule so that claimants receive full compensation for the loss caused by the wrongful injury neither more nor less.[22]

19. Witnesses agreed that the Government should adhere to the "full compensation" principle. The Association of British Insurers ("ABI") told us:

> We certainly accept … that the principle of 100% compensation is absolutely the right one to work from. Parliament got it right 21 years ago when it passed the Damages Act, and that principle should be at the heart of any reforms.[23]

Other insurers expressed support for the objective of 100% compensation.[24]

20 Cm 9500, para 3
21 Cm 9500, para 11
22 Cm 9500, **para 3**
23 Q42
24 The Medical and Dental Defence Union of Scotland (IDR0005) para 4.2, LV (IDR0006) para 12, esure Group plc (IDR0016) para 1, Ageas Insurance Limited (IDR0019) paras 13–14, Aviva (IDR0023), Advantage Insurance Company Ltd (IDR0024) paras 15–18, ABI (IDR0029), and British Insurance Brokers Association (IDR0030) para 31

20. While the principle of "full compensation" is agreed by all, it is less clear what it means. Ageas Insurance Limited described the concept of under- and over-compensation as "elusive because it can only be known after the period covered (often that between award and death)".[25] The Institute and Faculty of Actuaries (IFoA) believed it "crucial to investigate what 'compensated in full neither more or less' means in practice". They pointed out that the Government could only achieve full compensation *on average*; full compensation for individual claimants is largely determined by whether they live longer or die sooner than expected:

> The lump sum award is designed to meet loss over the expected future lifetime of the claimant. The expectation of future lifetime will be an expectation on average of a given sample of the population. In reality, very few individuals will live exactly for their expected future lifetime. As such, compensation can only ever meet the expectation of future lifetime costs in aggregate. Some claimants will die earlier than expected, meaning the lump sum was greater than required. However, other claimants will live for a shorter[26] period than expected, meaning compensation is insufficient for their actual lifetime.[27]

21. Lord Keen acknowledged that it is "not an exact science"[28] and agreed:

> No matter where you place the discount rate, … there is always the potential for some victims to be undercompensated, just as there is the potential for many victims to be overcompensated.[29]

22. The Government refers to "full and fair compensation" but also to defendants "no longer pay[ing] greater than 100% compensation because of the application of an artificially low discount rate".[30] It presumably means 100% compensation on average, but this is not made explicit.

23. Notwithstanding the Government's commitment to "full compensation", the impact assessment that accompanies the Command Paper notes that the legislation, if enacted, "will lead to a higher PIDR" and "this will result in smaller lump sum compensation payments, which will be a cost to claimants"; but on the other hand, defendants will benefit.[31] What is unclear is whether the Government is targeting 100% compensation on average, with around half of claimants being undercompensated, or something else. As the Forum of Complex Injury Solicitors ("FOCIS") put it:

> If the law is to change to force seriously injured claimants to take investment risk the debate needs to look at the flip-side of alleged over-compensation: what proportion of them do we consider it fair to potentially go "*under-compensated*"?[32]

25 Ageas Insurance Ltd and Tesco Underwriting Ltd (IDR0019), para 4
26 We understood the IFoA to have meant "longer", and not "shorter".
27 IFoA (IDR0040), para 7
28 Q87
29 Q89
30 Cm 9500, para 17
31 MoJ, Setting the Personal Injury Discount rate: Impact Assessment, July 2017
32 Forum of Complex Injury Solicitors (IDR0037), para 4

24. **We welcome the Government's commitment to full compensation, neither more nor less.** ***However, we recommend that the Government clarifies what it means by 100% compensation. In practice a lump sum award will nearly always either under- or over-compensate claimants. Some will receive too much and some too little. If the Government is targeting a median level of 100% compensation in relation to interest earned on lump-sum investment, it needs to say so.***

Are claimants being over-compensated?

25. Although there was consensus about the 100% compensation principle, there was disagreement as to whether claimants are "over-compensated" now the discount rate is -0.75%.

26. The proposed new Schedule A1 to the 1996 Act would require the Lord Chancellor to set a rate that a claimant "could reasonably be expected to achieve", assuming the lump sum is invested in a "diversified portfolio" involving "more risk than a very low level" but "less risk than would ordinarily be accepted by a prudent and properly advised individual investor" with different aims. In doing so, the Lord Chancellor must "have regard to" actual returns available to investors, and investments made by claimants.[33]

27. The draft legislation is therefore founded on the principles that:

- investment behaviour should determine the discount rate, and
- claimants invest in "low-risk" diversified portfolios.

28. These two principles mark a departure from existing case law, which sets the discount rate according to the return on Index Linked Government Securities (ILGS) which is considered to be a "risk-free" or "very low risk" investment. The appropriateness of these principles is examined below.

Should the discount rate reflect claimant behaviour in practice?

29. The Government's position is that the rate as it stands "may produce significantly larger awards than provide 100% compensation" because claimants are investing in "low-risk" diversified portfolios and are therefore likely to earn a higher rate of return than the discount rate, which is set assuming investment in ILGS (very low risk).[34] However those representing claimants say that even if claimants earn a higher rate of return than the discount rate, this does not amount to over-compensation.

Claimants earning interest in exchange for risk

30. Professor Victoria Wass argued that claimants earning a higher rate of return than the discount rate are not "over-compensated"; they are earning a premium for taking on more risk:

> If … the claimant accepts a greater risk in return for the opportunity for financial gain, that is up to the claimant. S/he ought not to be required to do so and it is of no concern to the Court or the defendant whether or not this is subsequently chosen.[35]

33 Cm 9500, pp 15–16 (new Schedule A1, paras 4(2); 4(3)(c) and (d); and 4(5)(a) and (b))
34 Cm 9500, paras 6– 7
35 Professor Victoria Wass (IDR0008), para 1

Underlying under-compensation of claimants

31. Some evidence suggested that even when the discount rate assumes risk-free or "very low-risk" investment, claimants are under-compensated for a host of other reasons. Richard Cropper told us a claimant "gets to recover zero in respect of their future accommodation", so they "start off with insufficient capital in their pot to meet all their future needs"; and "care costs and earnings rise over the long term at a faster rate than prices".[36] On the other hand, the ABI argued:

> this view of care cost inflation is out of date. The ASHE [Annual Survey of Hourly Earnings] figures confirm that the current rate of inflation in care earnings is below RPI and in the longer term is expected to be close to RPI".[37]

32. The IFoA pointed out "Even if investment performance matches or exceeds the assumed discount rate, a claimant living much longer than anticipated will exhaust their assets."[38] Those representing claimants also advised us they saw no evidence of over-compensation in claimants' behaviour. Brett Dixon from APIL told us:

> As a practitioner, I do not see people behaving like they have a lottery win or money that they can freely invest. What they and their families actually have is a pot of money that has to last them for the rest of their lives. They have no other way of making any money, earning or otherwise, and their biggest focus is making sure that that money is available to meet their need.[39]

33. **It is possible that claimants may be "under-compensated" even when the discount rate is set at a "risk-free" rate because compensation may be inadequate for their accommodation needs; they may be living longer than expected or there may be real increases in their cost of care over time. *We recommend that the Government find a means of assessing whether the legislative framework is compensating claimants fairly for their losses; otherwise by increasing the discount rate to remove what it sees as one type of "over-compensation" (primarily over-compensation due to greater than anticipated earnings from lump-sum investment), it may be simply increasing levels of under-compensation for claimants who were already under-compensated.***

Relevance of investment behaviour to setting the rate

34. One of the foundations for the Government's decision to stop setting the discount rate by reference to ILGS is investment behaviour. Lord Keen told us:

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36 Q2

37 ABI (IDR0041). In contrast to evidence given by ABI, ASHE (Annual Survey of Hours and Earnings) data from the ONS shows that for 2016, growth of hourly earnings for care workers exceeded RPI inflation (though this was not the case for all years): care workers' median hourly earnings grew by 3.9% compared to 1.8% RPI growth (see ONS 2016, Table 26.5a; RPI data). The same dataset also shows that growth of median hourly earnings for all occupations was 3.3%, also well above RPI growth. There is also evidence that care workers' real wages are likely to increase in the future. Skills for Care published a briefing which states: "Given the National Living Wage is forecast to reach £9 by 2020, it is likely that the trend of decreasing real term pay will be reversed and care workers could see nominal and real term increases up to 2020" (Pay in the Adult Social Care Sector, December 2016).

38 The Institute and Faculty of Actuaries (IDR0040), para 9

39 Q9

> I think the problem is that ILGS is not used. We do not have a situation in which, generally speaking, claimants put their entire award into index-linked gilts. That just does not happen, so it does not present a realistic picture of what is happening.[40]

35. The ABI told us it would be "crackers financial advice" for anyone to invest in ILGS. They acknowledged they were appropriate when *Wells* was decided, but argued that because of their high price (due to scarcity and the financial crisis) they can no longer be used as a proxy for very low risk or no risk investment.[41]

36. Setting the discount rate with reference to ILGS returns was never based upon their actual use by claimants. *Wells* decided that investment behaviour was irrelevant to the discount rate[42] (as did the courts in Ireland[43]). The true reason for using ILGS was as a proxy benchmark rate which would protect claimants against RPI inflation, as the expert panel report to the Ministry of Justice confirmed.[44]

37. **It may seem intuitive that the discount rate should reflect actual investment behaviour. But we conclude that this proposition should not be adopted without some further critical examination.**

38. Professor Victoria Wass suggested that the discount rate could not be based upon investment behaviour because the discount rate itself affects investment choices:

> In temporal space, the discount rate comes before the investment choices. During the period between 2001 and March 2017, claimants were forced into risk-bearing assets in order to more closely match the return of 2.5% on which their lump sums were based.[45]

39. This point was also put forward by APIL: "While the discount rate was artificially high at 2.5 per cent, however, claimants were often forced into the invidious position of having either to take chances with their compensation by putting it into higher risk investments, or struggling to make ends meet".[46] The Government's 2013 research supported this, finding:

> some evidence that those who have more acute concerns about future uncertainties related to a feeling that their current compensation does not meet their needs, currently feel pressured into higher-risk investments than they would like.[47]

40 Q104

41 Q70

42 See *Wells v Wells* [1998] UKHL 27; [1999] AC 345, 394–5 and 373

43 British Institute of International and Comparative Law, *Briefing Note on the Discount Rate applying to Quantum in Personal Injury Cases: Comparative Perspectives*, April 2017, p 45: "plaintiffs are 'entitled to take their award to Las Vegas or place it on a horse in the Grand National in the hope that they may enhance it' "

44 Cox, Cropper, Gunn and Pollock, Discount rates: A report for the Ministry of Justice, October 2015, p 8. The availability of Index-Linked Government Stock (ILGS) enabled the Court to consider a theoretical framework within which a claimant could invest in a portfolio of ILGS which … would provide for the future losses or costs as they fell due, without risk of erosion through inflation … or loss of capital. The availability of ILGS then provided the most accurate way of assessing the value of future losses in real terms (at least relative to RPI inflation).

45 Professor Victoria Wass (IDR0008), para 11

46 Association of Personal Injury Lawyers (IDR0004), para 2

47 MoJ, Personal Injury Discount Rate Research, October 2013, p 64

40. Those representing the claimants also strongly made the case that investors were not normal investors who are chasing high returns; instead their investment decisions are based on their needs. Richard Cropper from PFP said:

> When we advise claimants about investment risk, it is to meet their need, not how much risk they are prepared to take and then maximise return. It is the other way round.[48]

He also argued that for claimants who do invest in the stock-market, returns earned in the past are a poor indicator of future returns due to stock market volatility:

> If we set the discount rate by reference to past returns, which is the only way in a basket, we are going to find ourselves increasing the discount rate at the peak and reducing the amount of compensation to a claimant who then has the most investment risk—having to invest today at what feels like an elevated price. If we then get a collapse, there will be pressure on the discount rate to fall. We give the most money to those with the least investment risk, because they get to invest at the bottom. It is counterintuitive.[49]

41. **We advise caution in considering evidence of claimants' investment behaviour to set the discount rate. Investment by claimants in higher risk portfolios could indicate they are under-compensated and forced into higher-risk investments to generate sufficient return for their future living expenses.**

Are claimants investing in low-risk diversified portfolios?

42. In this section, we consider what evidence there is that claimants invest in low-risk diversified portfolios rather than "very low risk" investments like ILGS.

43. The Government says this is clear, "taking the responses and the results of other research together".[50] When asked what evidence there was of over-compensation, Lord Keen responded:

> We have had submissions from both claimants and defendants about the issue of the discount rate and its impact upon the level of compensation that is received. We have the perceptions, for example, of insurers as well.[51]

44. Thirty-nine of 135 respondents to the Government's public consultation thought "claimants were investing in a low- to medium-risk mixed portfolio of assets".[52] The Government's 2013 research found that although claimants were cautious about investing, they tended to take on "a mixed portfolio of investments, rather than just relying on ILGS".[53]

48 Q4; see also Q10.
49 Q12
50 Cm 9500, para 6
51 Q91
52 MoJ, The Personal Injury Discount Rate: How it should be set in future [Consultation response], September 2017, p 10
53 MoJ, Personal Injury Discount Rate Research, October 2013, p 4

Government Actuary's Department analysis

45. Much of the evidence of over-compensation we received was based on the Government Actuary's Department (GAD) analysis, with many insurers and defence solicitors claiming it showed 95% of claimants to be over-compensated and the median level of over-compensation to be 35%.[54]

46. GAD analysed outcomes for claimants receiving a lump sum award under different illustrative discount rates. The outcomes were examined under two assumed investment strategies (portfolios) set by the Ministry of Justice.[55] The strategies were broadly derived from information provided by 4 firms of wealth managers and investment advisers and both strategies used a low-risk mixed portfolio approach. We received no evidence about how closely this information represents advice given generally, or how closely such advice is followed by claimants.

47. We did receive evidence that the "low-risk mixed portfolios" used in the GAD review are not appropriate as a benchmark for claimants. PFP said that the portfolios considered by GAD could not be considered 'low risk' portfolios as they contain too great a proportion of equities.[56]

Claimants keeping funds in cash

48. It is also unclear how many claimants do not seek investment advice and simply choose to keep their funds in a bank account. We received evidence to suggest that these claimants may well not be earning positive returns on their lump-sum, given current market conditions. Solicitors Slater and Gordon UK LLP thought it might be common for claimants to invest in an "easy-access savings account". They calculated that against RPI, such claimants would be losing over 2.5% in real terms.[57] Richard Cropper of PFP told us some of his clients have no other option but to keep their investment in cash:

> I have clients who unfortunately have less than 10 years to live. They have no capacity for loss, so they are in cash. … They are getting negative 3.5% real and net. They are being woefully undercompensated, even at the current discount rate.[58]

Financially vulnerable claimants

49. The Government's 2013 research also indicated that gathering data solely from financial advisers may exclude financially vulnerable claimants:

> the breadth of the claimant sample for this research was limited by the need to recruit predominantly through financial advisors. In view of this, the claimant sample was likely to include claimants who were more aware or

54 Government Actuary's Department, Personal Injury Discount Rate Analysis, para 1.9; Q43, Keoghs LLP (IDR0001), LV (IDR0006), FOIL (IDR0007), esure Group plc (IDR0016), Zurich Insurance IDR0017, DWF LLP (IDR0020), Aviva (IDR0023), Advantage Insurance Company Ltd (IDR0024), RSA Group (IDR0025), ABI (IDR0029), BIBA (IDR0030)

55 Government Actuary's Department, Personal Injury Discount Rate Analysis, para 1.1

56 PFP (IDR0042)

57 Slater and Gordon UK LLP (IDR0011) paras 15–16

58 Q12

> supported in managing their claims. While the findings still indicated that claimants were a cautious and risk averse group, a more purposive sample may capture the most financially vulnerable claimants.[59]

Need for more data

50. The Law Society cautioned that "before proceeding with reform additional advice should be sought from investment advisors on actual Claimant investment behaviour" and "changing the framework without wider research risks creating an unfair framework based on assumptions which may not be accurate."[60]

51. Advantage Insurance Company suggested the legislation should be amended to require that "all professional deputies acting for claimants in personal injury claims file annual returns" to which the Ministry has access. Advantage Insurance suggested that data could be anonymised and "a set of standardised criteria would need to be devised to ensure that the specific data required by the expert panel & Lord Chancellor was provided in each annual return".[61] The eSure Group plc supported the idea of submission of anonymised data by professional deputies.[62] Lord Keen told us:

> the Lord Chancellor, when he comes to fix the rate, will be able to look at a wide body of evidence, as will the expert panel. If that sort of material is submitted, it will clearly be available for consideration.[63]

52. Moreover, the Federation of Insurance Lawyers ("FOIL") said that "full opportunity has been given to claimant representatives to present evidence on claimants' behaviour but very little has been forthcoming" and argued that therefore it is appropriate for Government now to assume "that claimants generally adopt a low-risk mixed portfolio approach".[64]

53. An adequate evidence base for policy changes is important: in 2012, the then Government introduced reforms to the legal aid system, in Part 1 of the Legal Aid, Sentencing and Punishment of Offenders Act 2012. Our predecessor Committee was critical of the failure to carry out adequate research.[65] **It may be reasonable to change the assumptions upon which the discount rate is currently calculated if they are indeed no longer representative of "real world" behaviour. However, we do not believe the evidence presented on this point so far is adequate.** ***We recommend that clear and unambiguous evidence is gathered about the way claimants invest their lump sum damages before legislation changes the basis on which the discount rate is calculated. If the rate is to take account of investment behaviour, a mechanism must be established to keep those responsible for setting the rate informed about that behaviour. This mechanism must ensure it captures the behaviour of those claimants who do not access professional investment advice and fund management.***

59 MoJ, Personal Injury Discount Rate Research, October 2013, p 66
60 The Law Society of England and Wales (IDR0039)
61 Advantage Insurance Company Ltd (IDR0024)
62 esure Group plc (IDR0016) para 3(a)
63 Q93
64 FOIL (IDR0007)
65 Justice Committee, Third Report of Session 2010–11, *Government's proposed reform of legal aid*, HC 681

Definition of "low risk"

54. Another problem identified with setting the discount rate according to "low risk" investments is that there appears to be no clear-cut definition of what "low risk" is.

55. Richard Cropper told us that there is no consensus about what "low risk" investment is and that the advantage of using ILGS to determine the discount rate is that their rate of return is accurate, whereas this is not the case with other assets:

> I have no idea how one defines what a low risk investment is, or where the border is between very low risk and low risk, where it becomes medium risk or where it is between medium and low. The beauty of index-linked Government stocks is that they do not predict the future. They are the future. That is the return you will get. With any other asset class, you have no idea; the crystal ball does not tell you. The most recent history is the least best estimator of future returns.[66]

56. PFP argued that the 'low risk' rate of return must be clearly and narrowly defined, if Parliament supports the move from 'very low risk' investment. They said:

> it should be measured by the observed standard deviation of the proposed portfolio of investments, and limited to a specific level of standard deviation … Without such definition, there will be too much scope for disagreement, subjectivity and bias whether the PIDR is being set by the Lord Chancellor or an expert panel.[67]

However, Lord Keen stated: "fixed parameters or definitions would prove potentially unhelpful going forward".[68]

57. The Government's Command Paper notes that there is likely to be "a range of portfolios and rates which might satisfy the parameters" in the draft clause of "more risk than a very low level" but "less risk than would ordinarily be accepted by a prudent and properly advised individual investor with different aims".[69]

58. Paragraph 4 of the draft clause requires that in setting the rate, the Lord Chancellor must:

- have regard to the actual returns that are available to investors; and
- have regard to the actual investments made by investors of relevant damages.

59. **There does not appear to be a consensus about what type of portfolio would be suitable to set a discount rate for claimants. There are likely to be multiple portfolios with differing rates of return that would fit into the Government's requirement of an approach involving (i) more than a very low level of risk, but (ii) less risk than would ordinarily be accepted by a prudent and properly advised individual investor who has different financial aims.**

66 Q30
67 PFP (IDR0021)
68 Q101
69 Cm 9500, para 12

60. ***We recommend that the Lord Chancellor publishes the basis upon which he or she has decided upon a particular rate out of the range available. We also think that it may be problematic for the Lord Chancellor to use investment behaviour of claimants to set the rate of return within the range. There are no such data widely available, and currently no mechanism in the draft legislation to obtain those data; and also claimants could be taking on more risk because they are being under-compensated. Until the Government obtains data on whether claimants are being appropriately compensated and not just with regard to investor risk, we recommend that the Lord Chancellor as a starting point sets the rate at the lower end of the range of "low-risk" to avoid the risk of under-compensation for claimants.***

International comparisons

61. Alongside its Command Paper and draft clause, the Government published a comparative study produced by the British Institute of International and Comparative Law ("BIICL report") which compared the UK with other jurisdictions in relation to the setting of the discount rate.[70] The ABI told us that along with the GAD analysis, this study provides further evidence that there is over-compensation in the UK:

> British Institute of International and Comparative Law looked at the discount rate for the UK versus 26 other common law jurisdictions and found that the new rate puts the UK at the lowest of the 27, whereas before it had been roughly in the middle. Both those independent areas point to a new rate that is likely to lead to overcompensation, and therefore not what Parliament intended[71]

62. However, the BIICL report also suggests that a simple comparison of discount rates may not present the whole picture. For instance, the BIICL report observes:

- negative discount rates are currently being considered in Ontario;[72]
- in other countries, discount rates affect fewer cases than the rate does in the UK; in Australia, the rate is determined by competing interests and takes into account the fact that too low a rate of return might have adverse consequences on the "provision and cost of liability insurance";[73]
- financial instruments such as ILGS may not be readily available in other countries; and[74]
- the way in which the award is calculated differs amongst other countries.[75]

63. **For the above reasons, we have found the international comparisons to be of limited assistance in determining what is the right approach for claimants and defendants in this country.**

70 British Institute of International and Comparative Law, *Briefing Note on the Discount applying to Quantum in Personal Injury Cases*
71 Q43
72 British Institute of International and Comparative Law, *Briefing Note on the Discount Rate applying to Quantum in Personal Injury Cases: Comparative Perspectives*, p 27, para 10
73 *Ibid*, pp 23–24, paras 15–16
74 British Institute of International and Comparative Law, *Briefing Note on the Discount Rate applying to Quantum in Personal Injury Cases: Comparative Perspectives,* p 13, para 40
75 *Ibid*, p 59, para 9

Periodic Payment Orders (PPOs)

Since 2005, the court has been able to award periodical payments in respect of future pecuniary loss.

The court must consider whether to make such a PPO, but cannot do so unless satisfied that continuity of payment is reasonably secure. Some payments are deemed secure, such as those from NHS, many motor insurers (if protected by the Financial Services Compensation Scheme), and the Motor Insurers Bureau.

64. Defendants argue that the existence of PPOs protects risk-averse claimants; claimants do not have to settle for a lump sum investment, which uses a "low risk" discount rate, instead they could ask for a PPO.

65. David Johnson from FOIL told us PPOs are a "route out for a claimant who is concerned about whether they can invest their damages to achieve the rate of return they need".[76] Huw Evans from the ABI said that "the area of the current system that most protects vulnerable clients is the existence of the PPO, because it ensures that they can never run out of money".[77] However, he said uptake was disappointing: the level of periodic payment orders has declined from 2012 and there is now about 10% uptake.[78]

66. Those representing claimants argue that PPOs are not always realistically available to their clients. APIL said: "For a claimant, there often is not a choice. If a defendant makes an offer to settle on a lump sum basis that puts the claimant at risk, they take it, or they run the risk and there is no PPO, even if a PPO might have been a far better way of delivering".[79] On the other hand, Emma Hallinan of the Medical Protection Society described claimant uptake as "minimal".[80] FOCIS, PFP and Stewarts Law suggested an amendment to Part 36 of the Civil Procedure Rules ("CPR") to require that any lump sum offer be made also on PPO terms.[81]

67. PPOs might not always be appropriate. Stewarts Law said "Until claimants are fully compensated for accommodation loss, this will continue to be a driver towards lump sum rather than PPO settlements."[82] The ABI pointed to strong behavioural reasons why claimants might prefer lump sums over PPOs, a "desire to have control over something, rather than to feel that they are just the recipient of an ongoing payments". Also, "if they take a lump sum, they may, depending on what happens to them, be in a position to leave some of that lump sum to dependants. People feel very strongly about that, given the loss of earnings for their lifetime".[83]

68. We were also told that insurers must reserve for PPOs at a negative discount rate of between -1.5% and -2%, because the regulator requires insurers "to reserve very

76 Q44
77 Q53
78 Q45
79 Q37 [Dixon]
80 Q46
81 Q39 [Cropper], IDR0035 Stewarts Law, and IDR0037 FOCIS
82 Stewarts Law LLP (IDR0035)
83 Q48

cautiously".[84] The ABI explained to us that the real discount rate used for reserving (before applying a risk margin) was between -3% and +0.5%, and that this was because they are required to reserve at a "risk-free rate".[85]

69. Lord Keen told us:

> There is mixed evidence about PPOs. There is some evidence that claimants are not particularly enthusiastic about them. There is some evidence that insurers are not always particularly enthusiastic about them, because of the regulatory regime that impacts on their capital requirements going forward, but, generally speaking, they are utilised in cases of catastrophic injury, where they are most needed.[86]

70. **PPOs offer a very useful alternative to lump sum awards, when appropriate, and can also be offered in combination with them. They transfer mortality and investment risk to defendants or the NHS, who are better placed to absorb those risks.**

71. **It is not certain whether the low uptake of PPOs is due to claimant or defendant reluctance or a mixture of the two. The enthusiasm of some witnesses, including those representing claimants, for amendment of the Civil Procedure Rules to make it a requirement for PPOs to be offered does not suggest claimants are strongly resistant. We believe that the low uptake means that PPOs cannot be viewed in all cases as a realistic alternative to a lump sum. Evidence that insurers must reserve for PPOs at negative rates means that PPOs are likely to be costly, and presumably less attractive, for insurers.**

72. **It is perhaps telling that insurers must be "cautious" and reserve for PPOs at a significant negative discount rate. Claimants must also be cautious, though for different reasons. We acknowledge that insurers are given no choice, but if a rate based on zero-risk investment is mandated for them, it strengthens the case for that being viewed as an appropriate investment strategy for claimants.**

84 Q49 [Evans],; see also Q37 [Cropper]

85 ABI (IDR0041); NHS Resolution have to reserve for PPOs at -0.8% in their accounts (Q26). This is currently set according to risk-free rate: HM Treasury, *Financial Reporting Advisory Board Discount Rate Update* (16 March 2017)

86 Q96

4 Balancing the costs and benefits

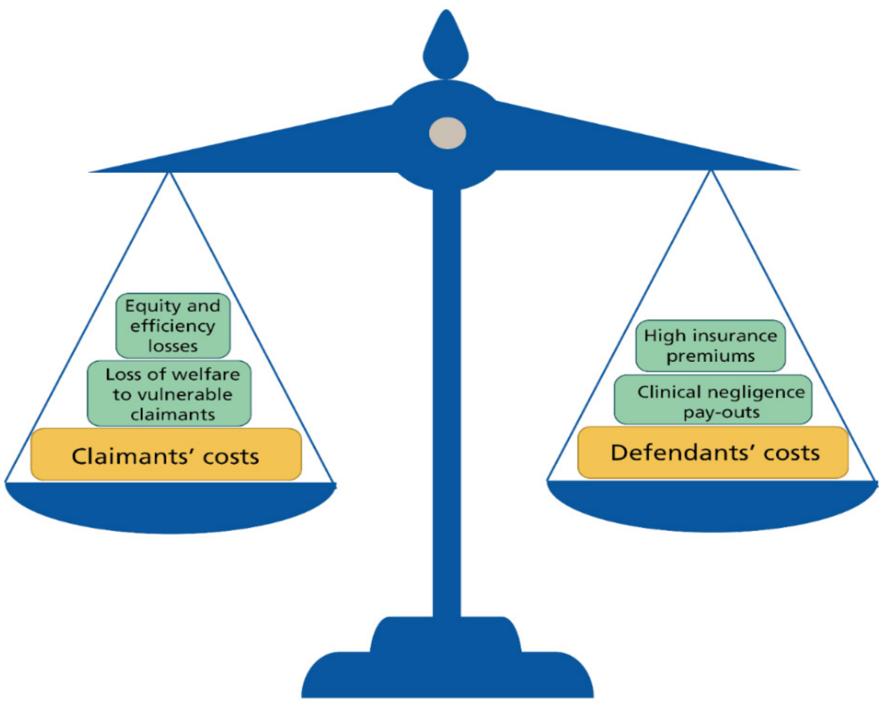
73. The Government's impact assessment confirms the proposals will lead to a higher discount rate because of the higher rates of return associated with "low-risk" mixed portfolios; and that smaller lump sum compensation payments will impose costs on claimants, while benefiting defendants.[87] Those representing claimants argue that increasing the discount rate would impose greater costs on a vulnerable sector of society and that this is not properly addressed in the Government's analysis.

74. A further driver behind the proposed legislation also appears to be the social benefits which would arise from lower insurance premiums and reduced clinical negligence costs resulting from the higher discount rate. The Command Paper argues that "The unrealistic assumptions currently being used" to set the discount rate:

> are having a significant effect on taxpayers through the additional cost of personal injury settlements paid by the National Health Service and other public sector bodies; and businesses and individual consumers through insurance premiums that are higher because awards of damages may be providing more than 100% compensation.[88]

75. We give below a graphic representation of the balancing act which we consider the Government is undertaking: the sizes of the weights on either side of the scales are not meant to be a proportional representation of the respective size of costs.

The Government's Balancing Act



Note: The sizes of the weights are not meant to be a proportional representation of the respective size of costs

87 MoJ, Setting the Personal Injury Discount rate: Impact Assessment, July 2017
88 Cm 9500, para 7

Quantifying the costs and benefits

76. As the Government says, "the discount rate has important financial and economic effects".[89] But the impact assessment does not quantify the benefits to the defendants or the costs to the claimants of the proposed legislation on the grounds that the "rate will not change until the Lord Chancellor conducts the first review under the new framework and so the impact of a rate change has not been quantified". However, as noted earlier, the Lord Chancellor indicated that a rate set now might fall "within the range of 0% to 1%".[90] The impact assessment confirms the proposals will lead to a higher discount rate because of the higher rates of return realised.[91]

77. We asked Lord Keen why the Government did not calculate the costs to claimants and benefits to defendants based on the estimated rate. He responded:

> I think one has to be careful. The figure of 0% to 1% that was given in the paper was not an estimate, essentially, of what the Lord Chancellor would be fixing as the discount rate. It was an assessment of the direction of travel of the rate, in the event that we moved from a very low risk portfolio to a low risk portfolio. It is based on figures in the Government Actuary's report that indicate a growth rate of about 1.3% during the first 30 years of an investment portfolio, moving up to 1.6% and then taking that back by about 0.5% to allow for management charges and tax. That is how the 0% to 1% figure was arrived at, but I emphasise that it was not intended as an estimate of what the rate will be. With the benefit of hindsight, it is perhaps unfortunate that the figure was there, but it was just to indicate the direction of travel when you moved the risk element of the portfolio.[92]

78. The Office for Budget Responsibility in its March Economic and Fiscal Outlook calculated that the recent reduction in discount rate from 2.5% to -0.75% would increase insurance premium tax receipts by "around £0.1 billion a year as the increased costs for the insurance industry, particularly in the motor sector, are passed on in higher premiums",[93] clearly indicating that it is possible to estimate how changes in the discount rate would affect costs to insurance companies.

79. **We believe that the Government should have given an estimate of the costs and benefits of the legislation in its impact assessment, based upon its "assessment" that the discount rate would be between "0% and 1%". This would have given Parliament and stakeholders a far better idea how this legislation will affect claimants in the short term.** ***We recommend that whenever the Government changes the discount rate under this legislation, it publishes at the same time an estimate of the costs and benefits of the change to claimants and defendants.***

89 Cm 9500, para 24, p 11
90 HC Deb, 7 September 2017, col 13WS
91 MoJ, Setting the Personal Injury Discount rate: Impact Assessment, July 2017
92 Q98
93 Office for Budget and Responsibility, *Economic and Fiscal Outlook* (March 2017), p 96, Box 4.2

Social costs

Effect on equity

80. The Government's impact assessment[94] indicates that the legislation will lead to greater equity (fairness) if there is a reduction in over-compensation. But Professor Victoria Wass argued it will lead to losses of equity and efficiency:

> There is inequity when you transfer risk from the claimant to the defendant.[95] There is also inefficiency, because claimants are going to be much less efficient than the Government and the insurance industry in bearing and managing that risk.[96]

81. Professor Wass also told us:

> In distributional terms, it is preferable to spread the cost of risk across society (tax payers and consumers of insurance) than to concentrate it on a few claimants[97]

Additional costs to the state

82. APIL also argued that if there is under-compensation, the state is likely to bear the brunt of care costs not covered by the award. This implies that the savings to the state are likely to be less than anticipated if the discount rate increases to benefit defendants:

> If they do not have the money available at the end—for example, in relation to care, because something has happened, say, they have invested it in a less than low risk way—the state picks it up, rather than the insurance company that took the premium for that risk.[98]

Costs borne by vulnerable groups

83. Professor Wass reminded us about the public sector equality duty:

> The public sector equality duty requires statutory decision making and Government Departments to pay due regard to the impact of their policy on protected groups. Virtually all claimants are disabled. They would qualify as a protected group under the Equality Act.[99]

94 MoJ, Setting the Personal Injury Discount rate: Impact Assessment, July 2017
95 In light of the rest of her written and oral evidence, we understood Professor Wass to have meant to say "There is inequity when you transfer risk from the defendant to the claimant".
96 Q27
97 Professor Victoria Wass (IDR0008)
98 Q9
99 Q28

84. APIL argued that how the Government sets its discount rate is indicative of how society treats its most injured:

> this is all about how society should treat people who are injured and how we deal with people when there is negligence, when somebody has been catastrophically injured.[100]

85. In its equality impact assessment,[101] the Government says its understanding of the impact of the proposals is limited by the fact it does not collect comprehensive information about the protected characteristics of personal injury claimants. It accepts, though, that those with particular protected characteristics (disability, age and gender) are likely to be more affected by the choice of a particular methodology for setting the rate.[102] The Government does not think such claimants will suffer a particular disadvantage. Even if they would, the Government believes this a proportionate means of achieving a legitimate aim.[103]

86. **When formulating policy for setting the discount rate, we would expect the Government to have given careful consideration to safeguarding the interests of those claimants who could be significantly under-compensated.**

87. **We do not think there is sufficient evidence for the Government's conclusion that its proposed legislation is a proportionate means of achieving a legitimate aim, so as to justify possible disadvantages to those with protected characteristics. Indeed, without adequate evidence about the protected characteristics of claimants, or the cost to claimants, it is hard to see how the Government can draw any sound conclusion about proportionality.**

88. ***We recommend that instead of targeting 100% compensation, neither "under" or "over" compensation, the Government should consider adopting as a target the median level of compensation to tend towards over-compensation; or should at least ensure that there are adequate safeguards to prevent significant under-compensation of the most vulnerable claimants.***

Social benefits

Motor insurance premiums

89. The impact assessment noted that there will be "benefits to wider society in terms of lower insurance premiums if insurance companies respond by reducing premiums and equity if there is a reduction in over-compensation".[104]

90. We received evidence that the recent reduction in the discount rate from 2.5% to -0.75% had increased pressure for insurance premiums to rise. In its written evidence, the ABI quoted a Will Towers Watson report as calculating that the reduction

100 Q9
101 Headed "Equality statement, at Annex B to MoJ, The Personal Injury Discount Rate: How it should be set in future [Consultation response]
102 MoJ, The Personal Injury Discount Rate: How it should be set in future [Consultation response], p 58
103 *Ibid*, p 59
104 MoJ, Setting the Personal Injury Discount rate: Impact Assessment, July 2017

"would increase the cost of motor insurance by £868 million per annum in the future".[105] The British Insurance Brokers Association ("BIBA") also blamed "recent increases in premium" on the "increased cost of catastrophic claims due to the change in the DR".[106]

91. Witnesses disagreed as to whether insurers would pass on any reductions in their costs to consumers in the form of reduced premiums. Lord Keen told us:

> one of the major motor insurers, LV, has already publicly stated that they will reflect the savings in premium savings … If one of the leaders in that market is going to pass on those savings, it would be surprising if others did not feel obliged to do the same.[107]

92. BIBA argued customers would benefit from an increase in discount rate; "any opportunities to cut premiums in order to attract customers are readily taken" because "many classes of insurance such as motor insurance are highly competitive". The ABI was more circumspect:

> Insurance premiums are affected by a number of different factors. The cost of whiplash claims, increasing repair prices and insurance premium tax rises as well as the large increase in claims and reserving costs caused by the discount rate announcement have all contributed to recent increases in insurance premiums. While insurers will strive in a highly competitive market to pass on savings to customers afforded by any future increase in the discount rate, premiums will ultimately be influenced by a range of cost factors.[108]

93. Access to Justice noted that it had commissioned economic analysis on the impact of the current proposed small injury claim reforms and this had shown that there "is highly unlikely to be any pass-through of savings" on to insurance premiums "without direct government compulsion".[109]

94. ***We recommend the Government report each time it reviews the discount rate on how changes in the rate impact on motor insurance premiums and the extent to which increases in the rate are reflected in reduced premiums, to use this information as a guide to setting the discount rate in the future. If changes in the discount rate do not lead to reductions in premiums as forecast by the Government in its impact assessment, it would mean that some of the social benefits of setting the discount rate based on a "low risk" investment rather than a "very low risk" investment had not materialised. The Government would need to take this into consideration when setting the discount rate at later stages.***

105 ABI (IDR0029)
106 BIBA (IDR0030)
107 Q99
108 ABI (IDR0029)
109 Access to Justice (A2J) (IDR0012); Capital Economics, London, *Boosting Insurers' Profits: an analysis of the impact of the UK government's proposed whiplash reforms* (March 2017)

Clinical negligence costs

95. The impact assessment noted that “defendants, including public sector bodies (such as NHS Resolution) and insurers, will benefit from lower lump sum payments”.[110] The former Lord Chancellor, when announcing the recent reduction in discount rate, drew attention to the repercussions it would have on clinical negligence costs.[111]

96. We were told that the discount rate reduction has sharply increased clinical negligence pay-outs. The MPS explained that the recent change in the rate from 2.5% to -0.75% would result in a sharp increase in clinical negligence costs. They pointed out that, in 2016–17 alone, the NHS paid out £1.7bn for clinical negligence claims.[112] Emma Hallinan from the MPS told us this “could have an impact on subscription rates, but [they] would have to weigh that with other factors”.[113]

97. In March 2017, the OBR stated that the reduction in the discount rate to 0.75% would affect their fiscal forecast: “the Government has added around £1.2 billion a year to the … reserve to meet the expected costs to the public sector, in particular to the NHS Litigation Authority”.[114]

98. Richard Cropper of PFP argued that the impact of the discount rate on clinical negligence costs was mitigated by the fact that for most large claims, PPOs were used and the Government currently must reserve for them at a negative rate of -0.8%:

> Changing the discount rate, which would have the greatest impact on care, case management and loss of earnings, if they continue to be paid in periodical payment terms, will not save the NHS a penny from an accounting perspective, because they will still be reserved for at negative 0.8%.[115]

99. Lord Keen told us: “This is not about reducing the cost of clinical negligence claims. This is about ensuring fair and reasonable compensation for those who become the victims of clinical negligence.”[116] But in Professor Wass’s view the Government needs to be more transparent about its motivations about the Bill:

> The question gets to the heart of what is driving the Bill: the cost to the NHS and the inflationary costs of car insurance. The Bill must be presented with that as the motivation—that the Government think that, for prudent fiscal and financial reasons, we should change the discount rate on the basis of a mixed portfolio. But we then cannot also claim that we are achieving the 100% compensation principle. You cannot have them both. You have to choose one or the other.[117]

110 Setting the Personal Injury Discount rate, Impact Assessment, 13 July 2017
111 HC Deb, 27 February 2017, col 2WS
112 Medical Protection Society (IDR0002)
113 Q66
114 Office for Budget Responsibility, *Economic and Fiscal Outlook* (March 2017), p 96, Box 4.2
115 Q26
116 Q94
117 Q24

100. The report by the British Institute of International and Comparative Law noted that the setting of the discount rate in other countries was "often not a neutral application of figures" but represents "a balance between competing considerations", resulting in a:

> compromise between a discount that accurately reflects the real rate of return a tort plaintiff might obtain if investing in reasonably safe investments and one that takes into account the fact that too low a rate of return might have adverse consequences on the provision and cost of liability insurance.[118]

101. **It is not clear to what extent the proposed legislation is motivated by a desire to limit growth in clinical negligence costs and insurance premiums. We think it is reasonable for the Government to take into account the impact of the discount rate on clinical negligence payments and insurance premiums and it should be open about this.**

102. **It is clear from past Government action (or inaction) in changing the discount rate that setting the discount rate is more than a technical decision: it involves balancing the interests of the claimants with the defendants and also balancing the social costs of increased clinical negligence pay-outs and increased insurance premiums with protecting the interests of vulnerable claimants and reducing their risk of under compensation through interest rate movements.**

118 British Institute of International and Comparative Law, *Briefing Note on the Discount Rate applying to Quantum in Personal Injury Cases: Comparative Perspectives*, p 14, para 42

5 Process

Roles in the decision-making process

Under the draft legislation, the Lord Chancellor will set the rate after consulting an expert panel, other than on the initial review where only GAD will advise. The Treasury will also be consulted.[119] The expert panel will:

- be chaired by the Government Actuary, who will have a casting vote in the event of a tie;
- include four others: an actuary, an investment manager, an economist, and someone with experience in consumer investment affairs; and
- have a quorum of three, one of whom must be the Government Actuary.[120]

Lord Chancellor

103. The Medical Protection Society said "the Lord Chancellor should make the final decision" and also that "there will be circumstances where it will be appropriate that the Lord Chancellor should not follow the advice of the panel", because

> The need to balance fair, just and reasonable compensation for claimants against the resources available to consumers and taxpayers is a delicate exercise and we believe that the decision should rest with an elected official, who can properly weigh the broader societal balance which has to be considered.[121]

104. APIL suggested the Lord Chancellor should always "take account of" the expert panel's views and give reasons for his decisions. The Law Society, on the other hand, said "decisions on awards made by the courts should not be subject to political influence." So it considered that:

> the role of the Lord Chancellor should be removed entirely from the process of setting the Discount Rate, and … the recommendations of the independent panel should be binding.[122]

Panel members

105. Fourteen written submissions from both sides of the argument concerning the Government's proposals highlighted the importance of safeguarding the panel's independence. Proposed solutions were varied and included: declaration of conflicts of interest, public record of membership, balanced representation of all interests, scrutiny of membership by the Justice Committee, or barring anyone who has worked as an expert in court in personal injury cases. Some submissions suggested other panel members: a health care professional, an investment manager, a claimant lawyer, a representative of injured

119 Cm 9500, Schedule A1, para 2
120 Cm 9500, Schedule A1, paras 5–6
121 Medical Protection Society (IDR0002)
122 The Law Society of England and Wales (IDR0039)

people or of the insurance industry. **We consider that in deciding the membership of the panel regard should be had to the need to ensure it reflects the balance of interests concerned and represents a full range of expertise on the subject.**

Panel quorum

106. We received some evidence that the quorum of the panel was too small. NHS Resolution stated:

> the quorum for the expert committee is just three, which to our way of thinking is too small for such an important task, especially as the Government Actuary has two votes in the event of a tie. We believe that the quorum should be four as a minimum.[123]

107. **Setting the discount rate has repercussions on the taxpayer through government expenditure and also consumers through its impact on insurance premiums and inflation; therefore we think it is right that the decision to set the discount rate lies with the Lord Chancellor.** ***However, we recommend that whenever taking a decision on setting the discount rate, the Lord Chancellor should publish his or her reasons for that decision, the advice provided on the matter by the expert panel, and reasons for not accepting the advice of the panel whenever that occurs.***

108. ***We also recommend that the panel should have a quorum of four when any decision on advice to the Lord Chancellor is made. Again, this should be enshrined in the legislation. We also agree with the Law Society that the expert panel should be involved in the first review of the rate.***

Frequency of review

The draft legislation requires the initial review of the rate to start within 90 days of the legislation becoming law. Then the rate would be reviewed at least every three years, the clock running from the last review. Reviews would have to be completed within 180 days, and would come into force when the Lord Chancellor thinks appropriate. The Government explains the effect would be to "avoid overlong delays between reviews, which will make changes in the rate more predictable and manageable."[124]

109. The Medical Protection Society indicated that they thought it was a good idea for the discount rate to be reviewed regularly to avoid sudden changes, though they thought that a yearly change might be preferable to a change every three years, to ensure that "any rate changes would be relatively minor each time" and to "mitigate any incentive for the parties to attempt to delay settlements in the hope of a more beneficial rate in the future".[125]

110. On the other hand, Royds Withy King Solicitors in their letter dated 12 September 2017 to the Ministry of Justice argued that the review period should not be less than

123 NHS Resolution (IDR0031)
124 Cm 9500, para 14
125 Medical Protection Society (IDR0002)

three years "so that those reviewing the rate have the necessary data to assess investment changes, changes in the financial environment, etc.–any more regularly than that, and we believe there will be insufficient data to properly inform setting of the rate".[126]

111. We were told by claimants' and defendants' lawyers that a review every 5 years might be the best approach because of the length of time it takes to decide or settle claims. Keoghs LLP stated:

> the proposed 3-year rate review cycle would be too short. Personal injury cases do not have to be issued until three years from the date of the accident and litigation in serious injury cases can typically be 3 to 5 years. In that period, the rate could feasibly change 3 times, resulting in uncertainty for the claimant and additional costs for advisers to re-calculate damages on different rates. Once the first rate is fixed a 5-year cycle is a more sensible term.[127]

112. The IFoA and NHS Resolution were both concerned that a periodic review of the discount rate and anticipations of how the discount rate is likely to move would impede the settlement process. The IFoA were concerned that an infrequent change in the discount rate "would lead to a significant change in behaviour of claimants and defendants trying to rush, or delay, settlements to take advantage of any expected change". They noted:

> Reviewing the rate every three years does not alter that understandable desire to time the date of settlement to gain the maximum benefit. To help mitigate this risk, we would encourage the review to be completed within 90 days.[128]

113. NHS Resolution stated:

> once it is known that a review is underway–and this will be the case if three years have passed since the last one–settlement negotiations will be affected because parties who believe that the new rate will be favourable to them will refuse to settle at the existing rate. That was a feature of 2001, when claimants' lawyers believed that the Lord Chancellor would make a decision benefitting claimants.[129]

114. Sixteen written submissions agreed that a three-year period between reviews was acceptable. Ten preferred a longer period. Most of them proposed five years, but one proposed ten years. Five submissions advocated more frequent (up to annual) reviews. Eight submissions argued that an economic trigger would be preferable to a fixed period. The IFoA recommended "an annual check on the suitability of the rate given current market conditions."[130]

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126 Royds Withy King, representation to MoJ about Cm 9500 (not published)
127 Keoghs LLP (IDR0001)
128 IFoA (IDR0040)
129 NHS Resolution (IDR0031)
130 IFoA (IDR0040)

Short, frequent intervals between review	Long intervals between review
Rate **more likely to fit** with existing market conditions	Rate **may not match** existing market conditions
Risk of **insufficient data** on claimant behaviour to inform setting the rate	**May result in delays** as claimants and defendants attempt to settle at the most preferential discount rate
Possible greater **uncertainty** about what the rate will be at settlement of the case for both claimants and defendants	Possibly greater **certainty** about what the rate will be at settlement of the case for both claimants and defendants

First review

115. The Law Society was concerned that the first review of the current rate will take place without the expertise of the panel:

> The draft legislation sets out that the first post-legislative review of the current rate will take place without the expertise of the expert panel. However, the Government consultation response decided that the correct way to set the rate in the future is with the Lord Chancellor acting upon the advice of a panel of experts. With this in mind, we are concerned that the expert panel will not be involved at the outset of the new rate-setting process.

It recommended that: "All reviews, including the first, must include the expert panel."[131]

Timing of review

116. The Committee also received evidence that the timing of the announcement of the discount rate was critical for those in the insurance industry and NHS Resolution. NHS Resolution stated:

> If, for example, a new rate is announced shortly after 1 April in any year this will have a huge impact on the accounts of NHS Resolution, as stated in our consultation response, and may lead to difficulty in the accounts of the government as a whole being signed off.[132]

117. In its submission to the Government about the draft legislation, Zurich Insurance asked that: "new rates … be introduced mid-year with an expectation that any changes should not be dramatic enough to create major rate changes or tactical delays by claimants". It stated: "Government's sudden announcement in early December 2016 of its intention to review the Discount rate caused well-documented difficulties for insurers in complying with their year-end reporting requirements".[133] **Whether or not the new mechanism for setting the discount rate is introduced, we recommend that the Lord Chancellor should ensure that the timing of changes to the rate takes account of the need to minimise disruption to the finalisation of year-end accounts by insurers and the NHS.**

131 The Law Society of England and Wales (IDR0039), paras 12, 13
132 NHS Resolution (IDR0031)
133 Zurich Insurance, representation to MoJ about Cm 9500 (not published)

Setting the discount rate as risk-free rate

118. The IFoA argued that "a market-related risk-free rate" avoids a lot of the pitfalls of periodic reviews and moreover has advantages for insurance companies as well as claimants as:

> Setting fixed PIDRs that are prescribed periodically will continue to create inequities and distortions in settlements and behaviours, as well as uncertainty for insurance companies, which will be unable to hedge effectively changes in the discount rate and will remain exposed to significant reserve adjustments.

119. It argued that it would also be simpler for Government:

> One of the advantages of such an approach is that there would be no need to set up a panel to regularly review the rate. The risk-free rate would also remove any accusation of political bias towards claimants or defendants.[134]

120. **The Institute and Faculty of Actuaries' recommendation of setting the discount rate according to a risk-free rate has attractions. However, if the Government is determined to set the rate using a "low-risk" diverse portfolio, a periodic review is required.**

Differential discount rates

The draft legislation would continue to allow for the setting of different rates for different "classes of case". [135] The Government says this will allow different rates "by reference to the length of the award". [136] The draft legislation would also still allow the courts to use a different rate if appropriate.

121. There was some evidence of an appetite amongst insurance companies for different discount rates to be set which depend on the term of the claim. The ABI stated that "the industry favoured legislation enabling a dual or "stepped" rate option, in which different rates are set for different periods of loss in the same case."[137] Ageas Insurance Ltd stated that an approach "which recognises that risk can be managed by use of differently constructed portfolios over different time windows would be inherently fairer and, critically, protect against the risk of under compensation for claimants with short term losses."[138] Evidence to us pointed out that this was the approach in Ontario, where there is a rate "varying between the first fifteen years and any years thereafter".[139]

134 IDR0040
135 Cm 9500,Section A1(3) to be inserted into the Damages Act 1996 by subsection (1) of the draft clause.
136 Cm 9500, para 11
137 IDR0029
138 IDR0019
139 The rate applicable to damages in the 15 years following the start of the trial is the greater of either (a) zero, or (b) the average return rate on a prescribed day for specific long-term Government of Canada real return bonds, less ½ per cent and rounded to the nearest 1/10 per cent. The rate applicable to losses after 15 years from the start of the trial is 2.5% per year for each year in that period, an attempt to reflect the long-term real rate of return. British Institute of International and Comparative Law, *Briefing Note on the Discount Rate applying to Quantum in Personal Injury Cases: Comparative Perspectives, p 12, para 37*

122. Amongst those representing claimants, there was also some appetite for setting different discount rates for different heads of loss. FOCIS stated:

> There should be a different rate which is applicable to earnings-related heads of future loss, notably loss of earnings and future care and case management.[140]

123. Professor Victoria Wass argued that:

> The Bill strengthens the case for two discount rates: one for prices-linked losses and expenditures and a different one for earnings-linked losses and expenditures. An alternative would be a weighted average of the two.[141]

124. But the Law Society and others argued that setting different rates would be inappropriate because it would "add unwarranted complication"[142] to the case. One law firm, Curtis Law, said "It would be inappropriate, unfeasible and unworkable for different types of case to attract a different discount rate."[143]

125. ***We recommend that the legislation require the expert panel and Lord Chancellor expressly to consider whether to set different discount rates for different periods of loss or different heads of damage.*** **In both cases, the benefits need to be balanced by the added complexity it would bring to cases.** ***We recommend that when the panel considers this, it looks at the experience of jurisdictions where differential discount rates have been used.***

Management costs and investment advice

The draft clause states that in setting the rate, the Lord Chancellor must "make such allowances for taxation, inflation and investment management costs as the Lord Chancellor thinks appropriate"[144] .The Lord Chancellor must also assume that claimants are properly advised about investment.

126. In its evidence, the Law Society noted:

> There is an assumption within the draft legislation that the claimant is properly advised on investment of damages. In order for that assumption to be correct, it should be enshrined within legislation that the cost of obtaining proper advice on a regular basis be recoverable as part of a claimant's compensation.[145]

140 IDR0037
141 IDR0008
142 IDR0039
143 IDR0038
144 Cm 9500, Paragraph 4(5)(c) of the proposed new Schedule A1 to be inserted into the Damages Act 1996 by the draft clause
145 IDR0039

127. Lord Keen argued that "At the present time, under our law it is not possible to identify a distinct and separate head of damage based on professional advice" but:

> the Lord Chancellor will have regard to the fact that any investment portfolio will be the subject of management charges, and that will be reflected in the determination of the discount rate."[146]

128. However, it should be noted that the cost of obtaining investment advice is not the same as management charges, which reflect the costs of selecting and researching the investments.

Measures of inflation

129. The Government received some submissions that CPI may be a better indicator for inflation than RPI[147] in the context of setting the discount rate. In its submission to the Government about the draft clause, Tokio Millennium explained:

> we strongly believe that the correct measure of inflation to use should be based on CPI and not RPI. The RPI figure is flawed in its calculation method, not recognised internationally.[148]

130. The 2015 expert report commissioned by the Ministry of Justice included an extensive discussion about the merits of using CPI and RPI, and concluded that until ILGS were available which offset inflation measured by CPI as opposed to RPI, RPI was probably the right indicator to use for inflation.[149] However, if the Government no longer wishes to use ILGS to set the discount rate, the measure of inflation used becomes once again a topic for discussion.

131. ***We recommend that the expert panel advise the Lord Chancellor on the most appropriate way to take into account advice and management costs and inflation when setting the discount rate. The panel should consider whether the law should be changed to identify a distinct and separate head of damage based on professional advice. It should also consider the most appropriate measure of inflation to use, when setting the discount rate.***

146 Q97
147 RPI and CPI are both measures of inflation. However, they use different formulae and are calculated on a different basis. RPI tends to be higher than CPI. The RPI measure itself is no longer classed as a national statistic due to inherent issues with the methodology used to derive it
148 Tokio Millennium, representation to MoJ on Cm 9500, (not published)
149 Cox, Cropper, Gunn and Pollock, Discount rates: A report for the Ministry of Justice, 7 October 2015, Paras 3.34, 3.38

6 Consequences for the draft clause

132. In this chapter, we draw on our recommendations to suggest how the Government might amend and proceed with legislation.

133. It is legitimate to consider changing the assumptions made when setting the discount rate better to reflect "real world" behaviour, but the evidence currently presented by the Government concerning claimant investment behaviour is thin. Further evidence is required on this point. But there is ample evidence that the rate ought to be reviewed and set regularly, and we are convinced of the merit of an expert panel to assist the Government, with some fine adjustment of the process.

134. ***If the Government remains convinced that it must change the assumptions it makes about how damages will be invested, to adjust the balance between the interests of different groups of society, it should say so. In that case, we would recommend that the Government:***

a) ***undertake careful and representative research into the way claimants invest their damages, the reasons for their choices and the extent to which they obtain fair compensation, and with the benefit of that research review the legislation at an early stage to consider:***

   i) ***how its impact on claimants is reflected in the balance the legislation strikes; and***

   ii) ***whether to exercise the power to amend the assumptions by regulations which we recommend below; and***

b) ***amend paragraph 4 of the Schedule inserted by the draft Clause so that:***

   i) ***the investment approach is assumed to involve the lowest reasonable level of risk between the two levels set out in the existing draft; and***

   ii) ***the Lord Chancellor has power to amend the prescribed assumptions, in regulations to be made by statutory instrument subject to the approval of both Houses of Parliament (the "affirmative procedure");***

135. ***In relation to process, we recommend the schedule inserted by the clause be amended as follows:***

a) ***remove paragraph 2 (with consequential amendment) so an expert panel is involved in the first review; and***

b) ***amend paragraph 3 to require:***

   i) ***the panel and the Lord Chancellor expressly to consider whether to set different discount rates for different periods of loss and/or different heads of damage; and***

ii) ***the Lord Chancellor to publish his or her reasons for any decision to change the discount rate or to leave it unchanged, the advice provided on the matter by the expert panel, and reasons for not accepting the advice of the expert panel whenever that occurs; and***

c) ***amend paragraph 6 such that the panel is quorate only when 4 out of its 5 members are present.***

Formal Minutes

Tuesday 28 November 2017

Members present:

Robert Neill, in the Chair

Ruth Cadbury	Gavin Newlands
Alex Chalk	Laura Pidcock
Bambos Charalambous	Victoria Prentis
Mr David Hanson	Ellie Reeves
John Howell	

Draft Report (*Pre-legislative scrutiny: draft personal injury discount rate clause*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 135 read and agreed to.

Summary agreed to.

Resolved, that the Report be the Third Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Wednesday 13 December at 9.30am

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee's website.

Wednesday 1 November 2017	*Question number*
Richard Cropper, Personal Financial Planning, **Brett Dixon**, President, Association of Personal Injury Lawyers, **Professor Victoria Wass**, **Martin White**, Institute and Faculty of Actuaries	Q1–40
Huw Evans, Director General, Association of British Insurers, **Emma Hallinan**, Director of Claims and Legal, Medical Protection Society, **David Johnson**, The Forum of Insurance Lawyers	Q41–84
Lord Keen of Elie QC, Ministry of Justice House of Lords spokesperson	Q85–110

Published written evidence

The following written evidence was received and can be viewed on the inquiry publications page of the Committee's website.

IDR numbers are generated by the evidence processing system and so may not be complete.

1 Access to Justice (A2J) (IDR0012)

2 Advantage Insurance Company Ltd (IDR0024)

3 Ageas Insurance Limited (IDR0019)

4 Association of British Insurers (IDR0029)

5 Association of Personal Injury Lawyers (IDR0004)

6 Aviva (IDR0023)

7 British Insurance Brokers' Association (BIBA) (IDR0030)

8 CBI (IDR0014)

9 Clyde & Co LLP (IDR0018)

10 Curtis Law Solicitors LLP (IDR0038)

11 Direct Line Group (IDR0036)

12 DWF LLP (IDR0020)

13 esure (IDR0016)

14 FOIL (IDR0007)

15 Forum of Complex Injury Solicitors (FOCIS) (IDR0037)

16 Hilary Meredith Solicitors Limited (IDR0003)

17 Irwin Mitchell LLP (IDR0009)

18 Kennedys (IDR0022)

19 Keoghs LLP (IDR0001)

20 Lloyd's Market Association (IDR0013)

21 LV Insurance (IDR0006)

22 MDDUS (IDR0005)

23 Medical Defence Union (IDR0027)

24 Medical Protection Society (IDR0002)

25 Ministry of Justice (IDR0034)

26 Motor Accident Solicitors Society (IDR0028)

27 Mr Ali Khan (IDR0026)

28 Mr Christopher Daykin (IDR0015)

29 Mr Matthew Stockwell (IDR0033)

30 NHS Resolution (IDR0031)

31 Personal Financial Planning Ltd (IDR0021)

32 Professor Victoria Wass (IDR0008)

33 RSA Group (IDR0025)

34 Slater and Gordon (UK) LLP (IDR0011)

35 Stewarts Law LLP (IDR0035)

36 The Institute and Faculty of Actuaries (IFoA) (IDR0040)

37 The Law Society of England and Wales (IDR0039)

38 Thompsons Solicitors (IDR0032)

39 Zurich Insurance (IDR0017)

List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee's website.

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2017–19

First Report	Disclosure of youth criminal records	HC 416
Second Report	Draft Sentencing Council guidelines on intimidatory offences and domestic abuse	HC 417
First Special Report	The implications of Brexit for the Crown Dependencies: Government Response to the Committee's Tenth Report of Session 2016–17	HC 423
Second Special Report	Government Responses to the Committee's Reports of Session 2016–17 on (a) Prison reform: governor empowerment and prison performance (b) Prison reform: Part 1 of the Prisons and Courts Bill	HC 417