All change please

Charlie Cory-Wright QC and Sadie Crapper summarise government proposals for changing how the discount rate is set

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The moment we all were waiting for arrived on 7 September 2017 with the Ministry of Justice's announcement that the Lord Chancellor and Justice Secretary would lay draft legislation before Parliament that very day to change the way in which the personal injury discount rate is set, followed shortly thereafter by a long paper entitled *The Personal Injury Discount Rate: How it should be set in future*, and another, shorter, paper setting out the draft legislation (see reference box on p4). The aim of this piece is to provide the busy reader with a helpful summary of the contents of those papers. It will be followed by a commentary from Charlie Cory-Wright QC setting out his initial response to the announcement.

The Personal Injury Discount Rate

The three core issues examined by the consultation paper were:

- What principles should guide how the rate is set?
- How often should the rate be set?
- Who should set the discount rate?

It also addressed an ancillary issue of whether periodical payment orders are being used sufficiently.

The bulk of the paper deals with the results of the consultation and itemises the way in which the 135 respondents (ranging from insurers and lawyers to actuaries and forensic accountants) answered the 36 questions in the consultation.

Presumably with half an eye on a further challenge by way of judicial review, the paper makes clear that the government has carefully considered all the replies to the consultation and taken into account the results of research carried out by the Government Actuary's Department (GAD) and the British Institute of International and Comparative Law (see reference box on p4), as well as responses to questionnaires from the Wealth Management Association, the Personal Finance Society and the Association of Professional Financial Advisors about the investments that personal injury claimants would be advised to make. It answers the three questions as follows:

What principles should guide how the discount rate is set?

Claimants should be taken to be more risk averse than ordinary prudent investors, such that they would invest in low-risk but not, as currently assumed, very-low-risk investments such as index-linked gilts (ILGs) alone.

The government believes the current assumption that claimants will only invest in very-low-risk investments is unrealistic and may produce significantly larger awards than provide 100% compensation.

How often should the discount rate be set?

There will be a requirement for a review at least every three years.

Who should set the discount rate?

The government recognises there is a need for a fairer and better framework for the setting of the discount rate and intends to make the following changes to the law:

- The rate will be set by reference to expected rates of return on a low-risk diversified portfolio of investments, and in assessing those rates the actual investment practices of claimants and the investments available to them should be considered.
- The principles for setting the discount rate should be set out in statute.

'The government believes the current assumption that claimants will only invest in very-low-risk investments is unrealistic and may produce significantly larger awards than provide 100% compensation.'

- The rate is initially to be reviewed promptly after the legislation comes into force and, thereafter, at least every three years, with that period being re-set when the rate is changed. Reviews will be completed within 180 days of starting.

- The rate is to be set by the Lord Chancellor with advice from an independent expert panel, although the initial review will be by the Lord Chancellor with advice from the Government Actuary. HM Treasury will be a statutory consultee for all reviews. The expert panel will be chaired by the Government Actuary and include four other members with experience as an actuary, an investment manager and an economist, and experience in consumer investment affairs.

- It will continue to be possible to set different rates for different types of cases, including by reference to the length of the award.

- No changes are proposed to the law on periodical payment orders (PPOs).

Under the new law the discount rate will reflect the rate of return to be expected of a low-risk diversified portfolio but it will be for the Lord Chancellor to apply the legal principles set out in the legislation and on that basis to decide where in the range of low risk the rate should be set.

The key legal principle will be:

> ... that the rate should be the rate that, in the reasonable opinion of the Lord Chancellor, a properly advised recipient of a lump sum of damages for future financial loss could be expected to achieve if he or she invested the lump sum in a diversified low risk portfolio with the aim of securing that (a) the lump sum and the income from it would meet the losses and costs for which they are awarded when [they] are expected to fall; and (b) the relevant damages would be exhausted at the end of the period for which they are awarded.

As part of the exercise the Lord Chancellor will therefore be required to consider the investments available and actual investments made by claimants; and must make such allowance for taxation, inflation and investment management costs as the Lord Chancellor thinks appropriate.

Having set out its intention in the paper, the government published draft clauses to embody these conclusions. The draft clauses were laid before Parliament for pre-legislative scrutiny and the intention is to:

> ... introduce legislation to enact these proposed changes to the law into Parliament as soon as parliamentary time permits.

Once in place, the changes will be brought into force in the usual way by the Lord Chancellor who will also initiate the last review of the rate under the current law within 90 days. That review will apparently be completed within 180 days and a new rate set, if the Lord Chancellor considers a change is appropriate.

Interestingly, the analysis performed by the GAD examined the risk of under-compensation if claimants adopt a typical 'low-risk' investment strategy, the kind of which the government is proposing to base the new rate on.

APIL have analysed the GAD modelling if a claimant adopted a typical 'low-risk' investment strategy, as follows:

- They would have a 30% chance of being under-compensated by 5% or more if the discount rate was set at +1 %.

- They would have a 19% chance of being under-compensated by 5% or more if the discount rate was set at +0.5%.

- They would have an 11% chance of being under-compensated by 5% or more if the discount rate was set at 0%. According to the government, if the proposed new system was applied today, 'the rate might be in the region of 0% to 1%'.

- If a claimant adopted a typical 'low-risk' investment strategy under the current -0.75% discount rate, they have a 4% chance of being under-compensated by 5% or more.

Thus, if APIL's analysis is correct and assuming that investments perform as projected by GAD, these figures suggest that a significant number of claimants could be under-compensated if discount rates are set at 0-1% even if, as the government assumes, they pursued a 'low-risk' rather than a 'very-low-risk' investment strategy. The GAD analysis also ignores the investment fees, management charges, adviser fees and taxes that claimants will be required to meet. If these costs were taken into account, the claimant could be at even greater risk of under-compensation.

The draft legislation

The foreword by the Lord Chancellor invites comments on the draft discount rate legislation which has been prepared to implement the government's proposals as set out above, but also makes clear that the government:

> ... intends to legislate promptly to make sure that the way the rate is set is put on the best possible footing at the earliest practicable date so that we have a better and fairer system for claimants, defendants and society as a whole.

The latter point is developed further in the 'Summary of proposals' which says, at para 17, that (emphasis added):

> ... [c]laimants will continue to receive full and fair compensation, but by aligning the discount rate to how claimants invest in practice defendants and their insurers will no longer pay greater than 100% compensation because of the application of an *artificially low discount rate*.

It is also envisaged that the more frequent reviews should avoid sizeable shifts in the rate as the rate will be aligned with returns from investments more often and thereby avoid potential 'shock' to the financial system occasioned by substantial changes of rate for which the market is unprepared.

The draft legislation is drawn so as to enact amendments to the Damages Act 1996, albeit the legislation relates only to England and Wales. It carries forward the Lord Chancellor's existing delegated powers to make secondary legislation specifying the discount rate in a statutory instrument and the requirement on the court to take the rate prescribed by the Lord Chancellor into account subject to and in accordance with any rules of court made for this purpose. No transitional arrangements are proposed and any change in the rate made under the new provisions will not affect awards of damages, but will from the date the change comes into force be taken into account by the courts in assessing the rate of return to be expected from the sum awarded in place of the previously applicable rate.

Useful comments are made about the impact of the proposed legislation, in particular at para 27 which says:

> ... broadly speaking, based on the evidence currently available and without fettering the exercise of the Lord Chancellor's discretion in the future, the Government would expect that if a single rate were set today under the new approach the real rate might fall within the range of 0% to 1%.

This estimate is said to be based on the expected returns over longer award periods as set out in the GAD report which the MoJ commissioned, and also reflects the new assumption that claimants are to be assumed to be prepared to take a low level of investment risk.

Commentary

Charlie Cory-Wright QC provides his initial comments and advice (written on the day the announcement was made):

- There are obviously two main structural changes proposed:
  - the proposed change to the method to be adopted when setting the discount rate, so that (if set today) it would be somewhere in the range of 0 to +1%; and
  - inbuilt flexibility (by way of three-yearly reviews).
- The thinking behind these changes is as follows:
  - Most importantly, the underlying assumption has changed: the notional claimant for these purposes is now assumed to be a low-risk investor, rather than a very-low-risk investor (who would place all of their damages into ILGs).
  - It is this low-risk investor approach which would, it is said, currently justify a discount rate in the range of 0 to +1%.
  - It is also this which justifies (if it weren't necessary already) the need for regular – as stated the proposal is for at least three-yearly – review.
  - There is also said to be greater transparency surrounding the process by which the discount rate will be set – which will include consideration of how claimants actually do invest their damages.
- Those measures are expressly stated to be introduced in order to remove the possibility of over-compensation for claimants because of an 'artificially-low' discount rate:
  - Set against a discount rate which is currently -0.75%, a level of return few investors would tolerate, it is hardly surprising that this is the language being used.
  - Nonetheless this statement might be thought to be of concern given that it appears to assume that the current rate is 'artificially low': it is a little odd that neither the concerns of the claimant lobby that claimants will be under-compensated, nor the theoretical possibility of reduction of the rate, are specifically addressed in the language of the response.
  - However the new overarching principles against which the rate will now be set (that the rate should be set at a level which assumes the properly-advised claimant will manage the lump sum to meet all their losses and costs but be exhausted at the end of the period for which they were awarded (usually the end of life)) would meet the concerns of both over- and under-compensation, but only so long as the investment landscape upon which the discount rate was set at the time damages were assessed does not significantly alter in the future.
  - Of course, in many higher-value claims both parties can be protected against such risks by the use of a PPO (assuming the defendant, or rather their insurer, is reasonably secure).
- The measures do seem to be intended as a permanent fix as to process. In so far as they introduce greater transparency to the decision-making process, that is to be welcomed. But as the key twin decisions of whether to change the rate and what level to set the rate at remain with the Lord Chancellor, there will certainly be greater and more frequent opportunity for political lobbying to have a specific effect on the discount rate in the longer term.
- As to timing, in summary the intention appears to be:
  - there will be a review under the current law to achieve a temporary rate change as soon as the changes are enacted;
  - that change of rate will be completed within 270 days of the enactment; but

References

- *The Personal Injury Discount Rate*, Ministry of Justice: www.legalease.co.uk/pi-discount.
- The *Personal Injury Discount Rate (draft legislation)*, Ministry of Justice: www.legalease.co.uk/pi-discount-draft.
- *Personal Injury Discount Rate Analysis*, Government Actuary's Department. Analysis of the impact of setting the discount rate using different risk appetites and investment strategies, including simulated modelling of various scenarios.
- *Briefing Note on the Discount Rate applying to Quantum in Personal Injury Cases: Comparative Perspectives*, British Institute of International and Comparative Law. Examined the issues of the discount rate applying to quantum in PI cases from a comparative law perspective, focusing on Australia, Canada, France, Germany, Hong Kong, Ireland, Spain and South Africa. This noted a broad range of rates from 6% in the Australian State of Victoria to 3.5% in Spain. No other jurisdiction had a negative discount rate.

- it is not yet clear when any enactment will be made and the draft changes still have to go through the Parliamentary process before they will be made and then come into force.

- Any changes to the rate will not be retrospective but as soon as the Lord Chancellor announces a rate the courts will have to take that rate change into account, even if the mechanism for bringing it into force has not been completed. Without tight judicial control, this could result in a long period of tactical stagnation of claims by whichever side believes it will most benefit from a change in the discount rate.

- There remain unanswered questions on accommodation claims and the continuing application of *Roberts v Johnstone* [1989] using whatever is the prevailing discount rate. The appeal in *JR v Sheffield Teaching Hospitals NHS Foundation Trust* [2017] may shed more light on this issue (albeit that the judgment appealed against was based on the current discount rate) but is only due to be heard by 15 May 2018 (according to the Court of Appeal's case-tracker service as at 7 September 2017).

- Generally, it is important to see these proposals in the litigation and market context as it currently is, which includes the following:

  - In real terms, the market has continued to function even with a discount rate which has been viewed as 'artificially low', in that cases are still settled or settled as far as they can.

  - The valuation of cases is primarily still (as it always has been) a function of multiplicand/risk on liability/contributory negligence; the discount rate issue is a stark one but has not prevented the market operating as before.

  - Regardless of the negative discount rate, many defendants have been operating on a 1% assessment so this change and the indication that, if set today, the discount rate would likely be between 0 to +1% is unlikely to require monumental shifts in the reserves currently held on claims.

- As such, overall the proposed measures are unsurprising. Speculation (which is never a good thing for litigation) will be calmed, and the flexibility as to the future is on the face of it welcome, if it is operated with a steady and even hand.

- There are however two possible structural concerns one might have (leaving aside strategic considerations for particular litigation, with which I deal below):

  - First it should be noted that one set of uncertainty and speculations will be replaced by others, which are built in to the proposed system: these measures will inevitably give rise to future uncertainty further down the line (particularly in the run-up to any three-year review).

  - What is impossible to tell from these proposals (whatever the intention in terms of design) is how in due course they will be operated: and in particular whether they will effectively end up being one-way (upwards) in terms of the rate. But it is perhaps premature to speculate about that.

- It will only be possible to tell how great these concerns are after we have experience of the operation of the system – ie probably not for five years or so.

Strategy for litigants now

We do not know precisely when the changes will come in, save that it will not be for at least nine months (270 days – see above). As stated above it is said that the changes are not to be retrospective in nature, and we should I think assume that they will only affect rulings made after the change has come into force, as opposed to claims issued after that date, or on the basis of some other test for transition.

If that is right then the simple advice one can give is as follows:

- As to claimants:

  - they have an interest in getting cases on quickly, and should issue and proceed quickly for that purpose, in order to take account of the current discount rate; but

  - any cases which are not coming on for trial in the next 12 months might sensibly be revalued (for short-term purposes at least) on the basis of discount rates set at 0% and 0.5% as well as the 1% which has taken hold of the market to date.

- As to defendants:

  - it would be in defendants' interests to delay (to the extent legitimate: applications for adjournments on this basis would be highly unlikely to succeed!); and

  - defendants/insurers will no doubt wish to re-reserve (if necessary) on cases where trials are not imminent if the discount rate used on the reserve was less than 0%.

- One needs to be aware that there will be further changes in due course, and indeed, it is of course possible that the whole system may have a wholly different and more radical overhaul further down the line.

- Overall therefore the additional advice that I would give to either party at the moment remains as currently:

  - Settle on the basis of some appropriate compromise on this issue that fits the facts of your case (attempting to articulate a 'one-size-fits-all' compromise proposal is of course impossible).

  - Generally, whether at trial or in negotiations, a PPO, where it is appropriate, is likely to do better justice all round between the parties, and is certainly the safer bet for all concerned. ■

JR v Sheffield Teaching Hospitals NHS Foundation Trust
[2017] EWHC 1245 (QB)

Roberts v Johnstone
[1989] QB 878