DISCOUNT RATE UPDATE

HISTORY

1. On 27 February 2017, the Lord Chancellor (LC) set the discount rate at minus **0.75%**, based upon a 3 year average of real returns on index linked government stocks (ILGS). In so doing, she was following the legal principles established in **Wells v Wells** [1999] AC 345. At the same time, she announced her decision to consult on a review of the legal framework before Easter.

2. The previous rate had been set on 27 July 2001 at **2.5%**. Despite consultations and pressure in the interim, the rate had remained unchanged although evidently unrealistic. An expert panel in 2015 had concluded that the rates should then have been:

ILGS	:	minus 1%
Very low risk	:	0%
Low risk	:	plus 0.75%

3. By way of illustration of the dramatic effect of the new rate, the multiplier for a 21 years old female with unimpaired life would change from:

2.5%	31.87
-0.75%	87.14

CONSULTATION

4. On 30 March 2017, the Government published its consultation "*The Personal Injury Discount Rate: How it should be set in future*" with a closing date of 11 May 2017. The rapidity of the consultation, and the short consultation period, underlined the Government's intention urgently to review the legal framework.

5. On 7 September 2017, the LC published the response to the consultation, together with draft legislation, accompanied by a report by the Government Actuaries Department. The latter indicated that average returns under the new rate exceeded the expected return by almost 35% (perhaps reducing to an excess of 20/25% after allowance for tax and costs of investment management).

6. The principal conclusions were:

   a) the ILGS approach should be replaced by a reference to expected rates of return on a "*low risk*" diversified portfolio of investments;

   b) the rate should be reviewed within 90 days of legislation coming into force, and thereafter every 3 years at least;

   c) the rate would be set by the LC after consultation, **at the first review with the Government Actuary and HM Treasury**; and at subsequent reviews with an **expert panel**.

7. It is noteworthy that, although stating that it was not possible to predict the specific rate:

> "*Nonetheless, broadly speaking, based upon the evidence currently available... the Government would expect that if a single rate were set today ...* ***the real rate might fall within the range of 0% to 1%."***

JUSTICE SELECT COMMITTEE SCRUTINY

8. These proposals were subject to pre-legislative scrutiny by the Justice Select Committee of the House of Commons, which reported on 29 November 2017. The Committee was sceptical of the quality of the evidence supporting the adoption of the proposed new legal framework, especially the evidence of actual investment practices of claimants. Accordingly, it recommended that "*clear and unambiguous evidence is gathered about: the way claimants invest their lump sum damages before legislation changes the basis...".*

9. The Committee also pointed to the lack of any clear cut definition of what "*low risk*" is, and recommended that, until adequate data was available "*on whether claimants are being appropriately compensated and not just with regard to investor risk*", that "*as a starting point* [the LC] *sets the rate at the lower end of the range of "low risk" to avoid the risk of under-compensation for claimants*".

10. Various other critical recommendations were made, but most notably, in summary, that:

    a) the first review, as well as subsequent reviews, be undertaken by the expert panel;

    b) express consideration be required whether to set different rates for different periods of loss or different heads of damage.

11. If these recommendations had been accepted, significant delays in implementation of the new framework would have been expected.

GOVERNMENT RESPONSE

12. The Government's Response was published in March 2018. In summary:

a) **the expert panel would be involved in the initial review**;

b) although it was not accepted that the evidence was insufficient to justify proceeding with the proposed reforms, the Government would work to develop further the existing evidence base by:

- calling for further evidence on investment behaviour

- commissioning the Government Actuary's Department to carry out further research and analysis of assumptions about inflation, tax and management costs

- commissioning the Government Actuary's Department to carry our further analysis about the effect of a range of rates under a wider range of assumptions (eg, length of awards);

c) require the LC to give reasons, and publish the expert panel's report;

d) require the LC to consult the expert panel about allowances for taxation, investment management charges and inflation; and consider whether the Government or a third party should review whether investment management costs should be recoverable as a head of damages;

e) publish an impact assessment on the effect of the change of rate every time it is changed;

f) amend the Legislation to make clear that differential rates may be set on the basis of duration or heads of loss.

In addition, there were to be further attempts to encourage the use of periodical payments.

13. Presumably, the actions promised at 12.b) have already commenced, because the Response states:

> "*To help prepare for the first review... which will follow shortly after the legislation comes into force, the Government will call for evidence of investments made by claimants and the investments available to them and arrange for further analysis of the returns likely to be obtained during the passage of the Bill.* ***The first review will then be able to be carried out with the benefit of up to date evidence and analysis***."

14. The Response **rejected** calls for "*a predetermined or more specific criterion for identifying where within the permitted range the discount rate should be*". Although there would be a range of rates within the statutory framework, the choice "*should instead be a* ***matter of judgement of the LC*** *to make in the light of the circumstances prevailing at the time of the review*."

15. Notably, despite the estimation (see paragraph 7 above) of a likely rate of 0-1%, the Response indicates that *"the publication of the figure was* ***not*** *intended to represent the outcome of the review."* It concludes:

> "***The Government does not consider that it would be appropriate to speculate on the outcome of the first review of the rate under the new law."***

16. Finally, in relation to the Response, there is a clear statement:

> "*The Government intends to begin the first review* ***promptly*** *after the legislation is enacted but does not consider that the specified periods for the conduct of reviews can sensibly be reduced*."

<u>CIVIL LIABILITY BILL PASSAGE</u>

17. The **Civil Liability Bill** was introduced in the House of Lords on 20 March 2018. (It includes "*whiplash*" reform which is not considered here, but the whole of the Bill is appended to this paper for reference.) The relevant section on the personal injury discount rate underwent significant amendment in the House of Lords before the Third Reading on 27 June 2018. In particular, despite the recommendations of the Justice Committee, and the Government's Response:

    a) the **initial review** is to be undertaken **without the involvement of the expert panel**;

b) the **review period** for the initial review is **shortened from 180 days to 140 days**.

c) Subsequent reviews are **extended from a maximum of 3 years to 5 years**.

18. The Bill was introduced in the House of Commons on 28 June 2018, and received its Third Reading on 23 October 2018. No changes were made to the relevant section 10, but an additional section 11 was inserted enabling the Treasury to require that insurers provide information about the effects of the changes (including the "*whiplash*" provision), so that the Treasury may report on how policyholders have benefitted from cost reduction as a result of reforms before the end of a period of one year from 1 April 2024.

19. Because of amendments introduced in the House of Commons, the Bill must be returned to the Lords for consideration of these amendments. This will take place on **20 November 2018**. If accepted (and it is perhaps unlikely to be controversial), the Bill will merely require Royal Assent, whereafter the relevant section on discount rate **immediately** comes into force [see section 14(2)].

<u>CORE PROVISIONS</u>

20. By section 10 of the Bill, a new section A1 is to be inserted before section 1 of the Damages Act 1996, which includes a new Schedule A1 making provision about determining the rate of return. Specifically:

- section A1(2) retains the provision that a court is not prevented from taking a different rate if it is shown to be more appropriate; case law demonstrates that successful use of this provision will be rare

- section A1(3) allows for different rates for different classes of case, further particularised in section A1(4), with reference to:

  a) description of future recurring loss

  b) length of period of loss

  c) time when loss will occur

[eg, different rates may be specified for care and for earnings; or (as in Canada) different rates for shorter and longer periods of loss.]

21. The substance of the reform is to be found at Schedule A1(4). The rate should be that which a recipient "could reasonably be expected to achieve if the recipient invested the relevant damages for the purposes of securing that

a) the relevant damages would meet the losses and costs for which they are awarded;

b) the relevant damages would meet those losses and costs at the time or times when they fall to be met by the relevant damages; and

c) the relevant damages would be exhausted at the end of the period for which they are awarded."

This is a statutory definition of the common law 100% principle.

22. The **core assumptions** incorporating the reform are set out at Schedule A1(4)(2). The assumptions are:

a) that the relevant damages are payable as a lump sum;

b) that the recipient is **properly advised** on the investment of damages;

c) that the recipient invests the relevant damages in a **diversified portfolio** of investments;

d) that the relevant damages are invested using an approach that involves:

(i) **more risk 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**.

The assumptions are not limited (Schedule A1(5)).

23. By Schedule A1(5), the LC must:

a) have regard to **actual returns available**;

b) have regard to **actual investments made by actual investors of relevant damages**; and

c) make such **allowances for taxation, inflation and investment management costs** as the LC thinks appropriate.

24. By Schedule A1(5), the LC **must give reasons** when making a rate determination, and **publish** such information as the LC thinks appropriate about the **expert panel response**, or the **response of the Government Actuary**.

PROCEDURE

25. By Schedule A1(1), the **first review** must be started **within 90 days of commencement**, and each subsequent review **within 5 years** of the last review. It is for the LC to decide when, within such periods, the review is to be started.

26. **First review**:

By Schedule A1(2), the LC must conduct a review and make a determination **within 140 days of starting the review**. He must consult:

a) the **Government Actuary**; and

b) the **Treasury**.

The Government Actuary must be consulted within 20 days, and respond within 80 days thereafter (ie, leaving a minimum of 40 days for the LC thereafter to make a determination)

[Note: The original time period was 180 not 140 days.]

27. Thus, following the Royal Assent, a new rate (or rates) will apply a **maximum** of 90 + 140 ie **230 days** (approximately 7½ months) thereafter. The expectation, therefore, is that the new rate will be applicable from **about the summer of 2019**, at the latest (assuming Royal Assent by the end of 2018).

28. **Subsequent reviews**:

By Schedule A1(3), later reviews (a maximum of 5 years following the previous review) must be conducted and determined **within 180 days of starting the review**. The LC must consult:

a) the **expert panel**; and

b) the **Treasury**.

The expert panel must respond within 80 days.

29. The expert panel

By Schedule A1(6), the expert panel will consist:

a) the **Government Actuary, as chair**; and

b) 4 other members appointed by the LC, being:

- **an actuary**
- **member with experience of managing investments**
- **an economist**
- **member with experience in consumer matters as relating to investments**.

Provisions relating to the proceedings, powers and funding of an expert panel are contained at Schedule A1(7).

30. Several rates of return

Schedule A1(8) makes clear that if two or more rates of return are prescribed, the provisions for review apply separately to each rate of return.

SUMMARY

31. Barring any unexpected complications when the Commons amendments are considered by the Lords on 20 November 2018, the Civil Liability Bill will receive Royal Assent and be enacted before the end of the year. Currently the Bill has the short title "**Civil Liability Act 2018**" [section 15]. As regards the discount rate provisions, it will come into immediate effect [section 14(2)].

32. Thereafter, **within a maximum of 230 days**, a new discount rate(s) will apply. The period may be shortened if the LC commences the review within less than the 90 day maximum (see paragraphs 13 and 16 above). Any case heard after the new determination will be subject to the revised rate(s).

33. The statutory definition provides for investment in a diversified portfolio of investments involving "***more risk than a very low level of risk***" but "***less risk than would ordinarily be***

accepted by a prudent and properly advised individual investor who has difference financial aims".

34. This definition (as accepted by the Government) will involve "*a range of rates within the statutory framework from which a rate can be selected*..." The choice will be a matter of judgement by the LC. More precise definition was rejected by the Government.

35. An estimate of 0-1% was made in September 2017 (see paragraph 7 above). Rates may have changed since, and subsequently qualifications were made as to this estimate (see paragraph 15 above).

36. The involvement of only the Government Actuary and Treasury (and not an expert panel) on the first review, perhaps suggests the probability of a higher rate?

37. Will there be more than one rate on the first review?

RAYMOND MACHELL QC

5 November 2018