The Discount Rate: Whatever Next?

Introduction

On 27 February 2017, the Ministry of Justice announced the long-awaited change in the discount rate. The new rate took effect on Monday 20 March 2017. So far, it is unchanged.

The Lord Chancellor's announcement sent shockwaves through the legal and insurance world and was met with strong views.

Huw Evans, Director General of the Association of British Insurers, said this:

> "Cutting the discount rate to -0.75% from 2.5% is a crazy decision by Liz Truss. Claims costs will soar, making it inevitable that there will be an increase in motor and liability premiums for millions of drivers and businesses across the UK. We estimate that up to 36 million individual and business motor insurance policies could be affected in order to over-compensate a few thousand claimants a year.
>
> "To make such a significant change to the rate using a broken formula is reckless in the extreme, and shows an utter disregard for the impact this will have on consumers, businesses and the wider operation of the insurance market."

APIL's press release was as follows:

> People who suffer severe life-changing injuries can now be assured that the compensation needed to look after them is calculated correctly and is sufficient to provide care for the rest of their lives. It is what they need and deserve and APIL welcomes this recognition from the Lord Chancellor.
>
> But we must also note that this change is long overdue. People already coping with the most severe injuries have been deprived of the help and care they need for years. Meanwhile insurance companies, which have saved millions of pounds in unpaid compensation, have been aware that a decision to change the discount rate has been on the cards for six years, since APIL first began judicial review proceedings on the issue. They have had plenty of time to prepare for this change and the fact that many are now saying premiums will have to rise to cover the cost simply beggars belief.

The announcement had an immediate impact with claimants scrambling to withdraw or amend existing offers and defendants urgently considering whether such offers should be accepted. Now that the dust has settled, the time is right to enter the mind of the Lord Chancellor and answer the questions that must be on her mind: What next? Why me? And was it something I said?

Methodology

Under The Damages Act 1996, the Lord Chancellor has the power to set the discount rate. However, the rate had remained unchanged since the power was last exercised by Lord Irvine of Lairg in 2001 in the Damages (Personal Injury) Order 2001 (S.I. 2001/2301).

In setting the new rate, the Lord Chancellor and Secretary of State for Justice issued a written statement that might be regarded as setting out a conservative approach to her powers.

The Lord Chancellor said she was not persuaded by arguments that ILGs was not the "realistic or appropriate" basis on the grounds that use of mixed portfolios incorporated an element or risk. She did, however, acknowledge that those arguments had some merit.

She concluded that "a faithful application" of the majority view in Wells v Wells led to the conclusion that a portfolio of 100% index-linked gilts (ILGs) was the best measure of the return claimants could be expected to obtain. For those that need a reminder, the principles in Wells v Wells were full compensation and risk-free investment.

What are ILGs? In simple terms, they are IOUs issued by the government to finance government spending. They are index-linked because the value of the gilt on redemption is calculated with reference to the PRI.

Why are ILGs so low risk? Although the national debt is a subject of concern, the UK government has never technically defaulted on its debt. In other words, it has always paid the interest due on its debt, and it has always repaid the original loan back when the bond matures (i.e. when the IOU is due).

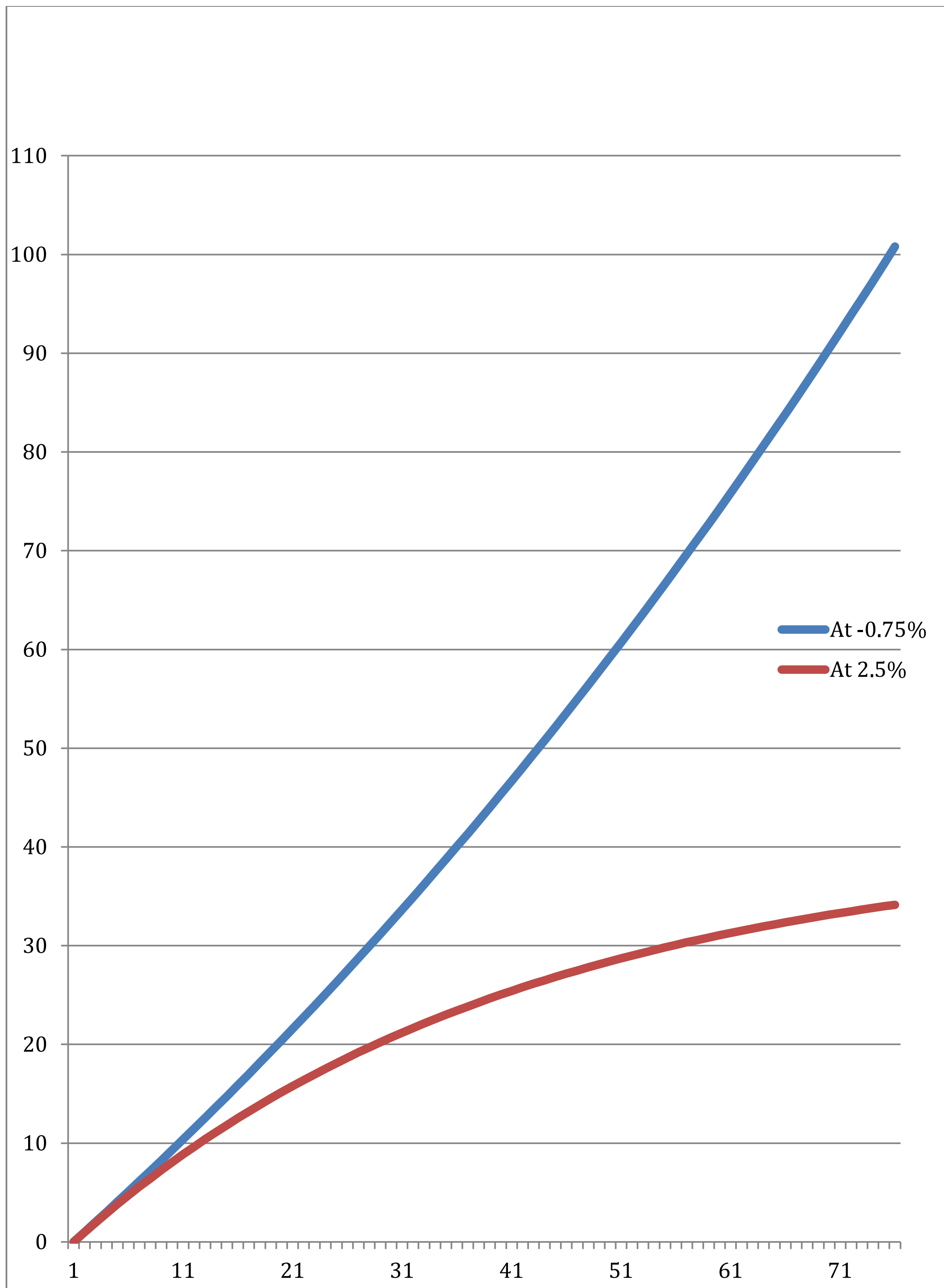
In line with her predecessor, in order to estimate the likely yield from ILGs, she took a three year simple average gross real redemption as at December 2016 of 0.83% but rounded this to -0.75%. She excluded stocks with less than five years maturity.

Why such a dramatic shift in the rate? Because there has been a steady decline in gilt yields, which have fallen since the financial crisis and, at the time of writing, have not yet shown signs of rising again.

Was it something I said?

The change in the discount rate has had a dramatic impact on nearly all claims with a future loss element.

The following table shows the divergence in Table 28 multipliers at 2.5% and 0.75% over the course of 80 years.



In accordance with a negative discount rate, the discount for accelerated receipt becomes an enhancement. At 2.5%, £975.61 would be awarded today to compensate for the loss of £1,000 in a year. At -0.75%, £1,007.56 would be awarded!

The longer the period of loss, the larger the impact. Thus, the life multiplier for a man aged 40 at 2.5% is 26.52; at minus 0.75%, it is 55.66. The overall increase is

therefore nearly 110%. A young catastrophically injured claimant would see the most dramatic difference. For a child of 10, the life multiplier at 2.5% would be 34.08. At minus 0.75%, it is 108.32, which is an increase of 217%.

Of course, those increases do not provide an accurate indication of the increase in the overall value of the claim. The main factors are the proportion of past losses to future losses and the losses taken as a PPO as opposed to a capitalised sum.

As a rule of thumb, Kennedys suggest that the average age bracket of a claimant is 30-40 and in such cases, the percentage of future losses to the overall claim is around 80-90%.

This may overstate the significance of the change. In the largest claims, a periodical payment order will need to be considered for the largest heads of loss. Except where liability is in issue, it is a brave claimant who elects to take a lump sum for all losses.

What Next?

The statement issued by the Lord Chancellor recognised the impact her decision would have and sought to poor oil on troubled waters with the simultaneous announcement of a review of the framework "to ensure it remains fit for purpose". The promise is that the consultation will start before Easter.

The consultation will cover:

> "[W]hether the rate should in future be set by an independent body; whether more frequent reviews would improve predictability and certainty for all parties; and whether the methodology - which in effect assumes that claimants would invest only in index-linked gilts - is appropriate for the future. Following the consultation, which will consider whether there is a better or fairer framework for claimants and defendants, the Government will bring forward any necessary legislation at an early stage."

This consultation bears more than a passing resemblance to the consultant that closed more than 4 years before the Lord Chancellor's decision was announced.

Those with long memories will remember that in November 2010 a review was announced in following a letter of claim under the pre-action protocol for judicial review. Judicial Review proceedings were commenced by APIL in April 2011.

On May 11 2011, it was announced that a consultation paper would be published "*soon, and the review will be completed as timely a basis as possible*".

On the 16th August 2011 Holman J dismissed the application. Although he was "*sympathetic*" to the application it had "*absolutely no prospect ... of succeeding*" with the Lord Chancellor's promised consultation paper being due by October 2011.

On 1 August 2012 the Ministry of Justice launched its long-awaited consultation on the methodology to be used in setting the personal injury Discount Rate. The consultation closed on 23 October 2012.

In the meantime, on 4 September 2012, the Parliamentary Under-Secretary of State for the Ministry of Justice, Jonathan Djanogly issued a written statement which indicated that independently of the first consultation the Ministry of Justice intended to issue a consultation paper in the autumn of 2012 to review the present legal basis for the setting of the rate in England and Wales.

It is said that the consultation will seek views on whether the restrictions on the factors that can be taken into account in prescribing a rate under section 1 of the Damages Act 1996 are still appropriate.

There were two parts to the earlier consultation. Some insight into the position that may be adopted on behalf the government can be gained by looking at the "overview" document issued at the time.

First, whether the methodology should be changed. It was suggested that many claimants did not invest in the cautious way envisaged by the existing "risk free" guidelines. It was suggested that might mean that rate was too low. The options under consideration were to retain the current Wells approach or set the rate by reference to investment strategies which may produce higher returns at the expense of higher risk.

Secondly, whether there was a case for encouraging the use of periodical payments. The Government expressed a wish to see PPOs as the norm in future loss cases. BLM suggests market data shows that still only roughly a third of cases over £1m settle with a PPO.

The Ministry of Justice received responses to the consultations but no response has ever been issued by the Ministry of Justice.

In 2015 a panel of experts was appointed to consider the responses to the consultations and advise the then Lord Chancellor on the rate review and they reported in January 2016. That report has not been published either.

Why Me?

One of the points of interest in the recent announcement made by the Lord Chancellor was the suggestion that a panel might be a more suitable body to set the rate and that the rate could be set more frequently. This points towards a possible move away from risk-free investment approach.

Where Now?

Few believe that the negative 0.75% rate will remain in the long term.

In the meantime, there is likely to be a window in which claims coming on for trial will have a significantly higher value. The question for practitioners is when that period will become and what will the rate become.

In the past, the process of consultation has moved slowly. No doubt the government will now be more highly motivated to consider the issue. On the other hand, the Ministry of Justice has its hands full. The position adopted by the Lord Chancellor in her announcement is an implicit concession that change will require legislation.

It is clear from the tone of the consultation that the government is considering moving away from the principles established in Wells v. Wells. It is difficult to believe that over 16 years having elapsed without any adjustment of the rate to changed economic circumstances, the government will be of the view that a claimant should be able to invest without risk.

It is obvious that current economic and political implications of the decision are at the forefront of the Lord Chancellor's mind. NHS Trusts and the MoD have a great deal to lose by a reduced discount rate. The current reduction in the discount rate will encourage Claimants towards lump sum awards that the NHSLA can ill afford.

The following signs point towards a move away from index-linked gilts:

- The long-term investment behaviour of those compensated is, in practice, not to invest in index-linked gilts. There were rumours previously that the government was looking at the approach of the Court of Protection.
- According to the ABI, the discount rate in Europe is typically between 1% and 4%.

For the moment, the current uncertainty surrounding the discount rate looks set to continue.

In the short term, the dynamics of large claims may reverse. The balance of benefit and disadvantage of a PPO will likely change with defendants encouraging the use of PPOs. Rather that claimants, it may be defendants who seek provision re-negotiation in the event of a change in the rate in 2018.

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