7 September 2017

Personal Injury Discount Rate

On 7 September, the Lord Chancellor announced reforms to how compensation payouts for personal injury victims should be calculated. Draft legislation has been published which, if enacted, will affect how the Personal Injury Discount Rate (PIDR) is set in future. This follows a consultation earlier this year on possibilities for how, when and by whom the PIDR should be set. This bulletin sets out some background to the PIDR and summarises the government's proposals for England & Wales.

What is the Personal Injury Discount Rate?

Claimants in personal injury cases may be awarded damages for future pecuniary losses, for example loss of earnings or future care costs. Damages may be awarded as a stream of payments over a given period of time (a Periodic Payment Order) or paid as a lump sum or some combination of the two. The PIDR is used to calculate the lump sum that should be payable such that, allowing for investment returns, it represents the value that the claimant would expect to need to replicate the losses.

The PIDR, also known as the 'Ogden' rate, therefore plays an important part in determining the cost of damages awards. Most commonly such awards arise from medical negligence, industrial accidents and road traffic accidents, where liable defendants will usually hold insurance. In addition to the effect on insurance premiums, the Office for Budget Responsibility[1] recently analysed the effect of changes to the PIDR on their fiscal forecasts, finding that changes to the PIDR will have an effect on:

- government spending: predominantly as a result of the cost of settling NHS medical negligence claims
- tax receipts: as changes to insurance premiums affect revenues collected from Insurance Premium Tax
- inflation: the changing cost of insurance premiums feeds through into inflationary statistics

When compensation is paid as a lump sum, the claimant takes on much of the associated risk. Risks that could lead to them running out of money include: the risk that they live longer than expected, that costs rise faster than anticipated or that investment returns are lower than assumed.

The existing framework

Under the current legal framework in England & Wales, the PIDR is set by the Lord Chancellor under section 1 of the Damages Act 1996, supported by principles established by case law. In particular, it was established in 1998[2] that: "*the object of the award of damages for future expenditure is to place the injured party as nearly as possible in the same financial position as he or she would have been in but for the accident. The aim is to award such a sum of money as will amount to no more, and at the same time no less, than the net loss.*"

This is the principle of 100% compensation – claimants should be neither over nor under-compensated. Using principles established at that time, the current PIDR is based on the yield on index-linked gilts (ILGs) - UK government bonds where payments increase in line with inflation. If claimants were to invest their lump sum in ILGs, this would offer a virtually 'risk-free' return (although, in practice, some residual risks would remain).

In February the previous Lord Chancellor announced the PIDR would fall from 2.5% to -0.75%[3] with effect from 20 March 2017, reflecting ILG yields. Acting on renewed calls for a re-consideration of how the rate is set, in March MoJ published a consultation seeking views on how, when and by whom the PIDR should be set.

What will the discount rate be in future?

The published documents do not set a revised rate. MoJ do, however, give an indication that, based on currently available information, if a single rate were set today under the new approach the real rate might be in the region of 0% to 1%. This is an estimate and does not necessarily mean the rate will change to between 0% and 1% when the review is carried out.

[1] see Box 4.2 in the OBR's March 2017 Economic and Fiscal Outlook
[2] in a House of Lords Decision known as 'Wells v Wells'
[3] both measured relative to the Retail Prices Index (RPI)

The proposed change in approach requires revised legislation. MoJ has published draft legislation for comment. Subject to considering comments received, the government intends to introduce legislation to Parliament to enact the proposed changes into law as soon as parliamentary time permits. The rest of this bulletin provides more detail on the proposals.

What principles should guide how the rate is set?

The consultation responses suggested that claimants are advised to, and are investing in, assets with a higher expected return than that of a portfolio of ILGs. In its response, MoJ confirms that the assumed investment risk profile of personal injury claimants should, in future, be ‘low risk’. This can be described as riskier than ‘very low risk’ (consistent with 100% investment in ILGs) but less than the risk expected of an ordinary prudent investor. Proposed principles for determining the rate are set out in the draft legislation.

MoJ asked GAD to analyse outcomes for claimants under different illustrative PIDRs. Published as part of the consultation response, [GAD’s analysis] focuses on the trade-off between investment risk and return. The report demonstrates the wide range of potential claimant outcomes and articulates the risks (and potential benefits) of different award sizes for a given investment strategy.

The illustrative figures in the report are based on a single simplified situation, ignoring mortality risk. Simulating a claimant’s fund under 1,000 economic scenarios, the likelihood and extent of under/over-compensation can be assessed. Two different asset portfolios were modelled based on evidence from wealth managers’ and investment advisers’ consultation responses as to how claimants typically invest.

The outcome for the claimant depends on both the investment strategy adopted and the basis of award. The charts show that even in this simplified situation there is a wide range of potential outcomes. Please refer to GAD’s report for further analysis and commentary on these findings.

Chart 1: Distribution of over/under-compensation on different award basis

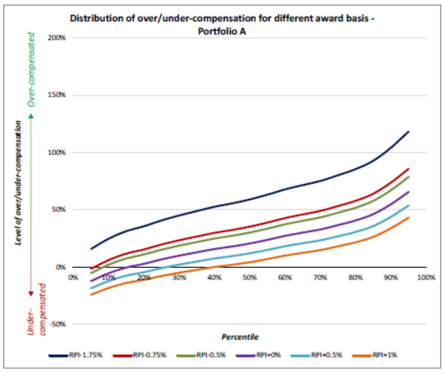
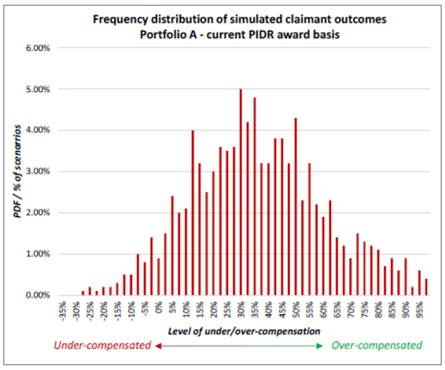


Chart 2: Frequency distribution of simulated claimant outcomes (current PIDR basis)



How often should the discount rate be set?

Respondents to the consultation were in general agreement that reviews should occur more frequently than previously and with greater predictability, but there was a range of views on what the appropriate period should be and whether it should be fixed. Arguments put forward in support of a fixed review period include the need for certainty and predictability; the need to avoid dramatic shifts in the rate; and the need to minimise scope for adverse litigation behaviour and delays in settlement.

The government considers a requirement to review the rate at least every three years represents a reasonable compromise between the differing views expressed. Reviews may occur more frequently than the maximum intervals specified in the draft legislation. The review period would be re-set whenever a review is concluded.

Who should set the discount rate?

Under the proposals, the rate will continue to be set by the Lord Chancellor who will be advised by an independent expert panel (other than on the initial review which will be by the Lord Chancellor with advice from the Government Actuary). HMT will, as at present, also be a statutory consultee for all reviews. The expert panel will be chaired by the Government Actuary and include four other members having experience as an actuary, an investment manager and an economist and, finally, experience in consumer investment affairs.

Once consulted the expert panel must respond within 90 days. All reviews will be completed within 180 days. A new rate will be set if the Lord Chancellor considers a change is appropriate, brought into force on a date to be specified by the Lord Chancellor. It is proposed that the option to set more than one rate for different classes of cases be retained.

If you would like to discuss any of these issues in more detail or have any questions please get in touch with your usual GAD contact.

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