Medical Defence Union response to
Ministry of Justice Discount Rate consultation paper

Q1: Do you consider that the law on setting the discount rate is defective? If so, please give reasons.

Yes. The 1998 decision in the case of *Wells v Wells* was made in a financial climate and based on economic assumptions that have long since ceased to be relevant. In addition to the changes in the financial and economic climate that have since taken place, there have been many changes in personal injury that have had a substantial and detrimental financial impact, for example, in clinical negligence where claims inflation has been running at a steady 10% for several years. This consultation document appears to be based on the premise that the way forward is to build on what currently exists, with the possibility of only moderate amendment. Such an approach is no longer sustainable, as the financial impact of the recent 3.25% decrease has demonstrated. Setting the discount rate is not just a legal decision and its impact financially and on the public interest cannot be ignored. The current law is not fit for purpose and needs a fundamental change. In *Wells v Wells* the House of Lords concluded that the financial impact on society was not a matter for them. It is a matter for government.

The premise that the current law provides full compensation (no more nor less) is a fiction and requires urgent change. The assessment of damages can never be exact. No investment is without risk and, furthermore, damages are often reduced for litigation risk and factors such as contributory negligence.

We do not know what level of compensation the law provides in practice as there is no evidence. For example, no robust evidence has been provided to substantiate the assumption that those providing investment advice to claimants advise investment only in 'low-risk' financial instruments and specifically in index linked government stocks. Nor has there been any robust evidence provided to substantiate the assumption that personal injury claimants invest in ILGS. The law currently disregards actual claimant investment behaviour and it should not. Further, there is very little useful information

about what happens to compensation awards and how they are spent. The decision-maker who sets the discount rate must be in possession of all this information because it is the only way to ascertain the extent to which claimants' awards provide under or over-compensation. Currently the law is based on an unsubstantiated guess which may bear little relation to what happens in practice.

A change in the discount rate has knock-on effects for the rest of society, for example the recent announcement by the Chancellor in the budget that the Government needed to provide an additional £5.9bn to cover the effect of the 3.25% discount rate decrease on the NHS for the forecast period of three years. Such changes, which increase liabilities with retrospective effect, must have a sound evidence base and the more profound the adverse effect of the change on any party, the more robust the evidence base needs to be.

Money spent on clinical negligence claims is money that has to be diverted from the provision of NHS services for all patients. The percentage of claimants treated for free by the NHS and receiving compensation as a result of negligent NHS treatment is disproportionately small in relation to the billions of patients treated now and in the future by the NHS which fund will have to be diverted to pay claims, rather than providing vital services for patients. This diversion of funds may impair services and increase the propensity to sue the NHS. It creates a vicious circle. It is illogical for the law to disregard the financial effect the discount rate has on public services, such as healthcare, and on other defendants when it substantially inflates the cost of the services they provide to consumers and the rest of society. The setting of the discount rate must take equal account of the effect on all parties.

The law is defective because it does not require the decision-maker to take into account the prevailing economic climate which increases the risk for all investors, claimants and defendants, and affects their returns in the same way as it limits or reduces the availability of public funds. Any economic or other financial changes that affect the returns that claimants may be expected to achieve on investment equally affect the ability of defendants to pay damages awards that continue to rise in a manner that bears no relation to the financial reality experienced by the rest of society.

The law is also defective as it has allowed a single decision-maker, the Lord Chancellor, to be the sole person to make a financial decision that has profoundly and adversely affected the funding of essential public and private services without any requirement to seek advice and input from other the Government departments. The MDU only has direct experience of the adverse impact on NHS funding, but the adverse effect of such a dramatic decrease will have been experienced far more widely in the public and private sectors. For example, it has had an adverse impact on insurance and on business more widely, such as on the ability of small business to continue to trade if the insurances they held are now insufficient and they do not have sufficient funds to pay the difference between their policy limit and a post-discount rate settlement. The law should include a safeguard that major decisions with wide-ranging effects must be made with input from all government departments and bodies affected.

Finally, although there had been consultations in 2012 and 2013, by 7 December 2016 the MoJ had not responded to those consultations and nor had it given any warning of its thinking, despite the change in the economic climate since the consultations. Nor did the MoJ seek to inform itself by asking for additional information from stakeholders about any material changes since the earlier consultations. The law must include a requirement for any decision-maker to ensure that the person/body making the decision is fully-informed and that must include holding a consultation exercise and engaging meaningfully with stakeholders to understand the potential effect of any change on them. The law should specify that such activity should take place close to the time the decision is made and certainly within a year.

Q2: Please provide evidence as to how the application of the discount rate creates under- or over-compensation and the reasons it does so.

We do not know what happens to the lump sum awards we pay on behalf of our members. More important, the MoJ does not have any substantive evidence of how lump-sum compensation awards are invested in order to be able to determine whether they create under or over-compensation. There must, for example, be over-compensation when a claimant dies at an age far earlier than the award had been expected to provide for and the remainder of the lump sum remains with the estate. We expect this happens

regularly because it is our invariable experience that courts err on the side of caution when considering submissions about life expectancy of a severely-damaged patient.

There are also provisions within quantum for fixed assets, such as houses with valuable adaptations, which will appreciate in value during the lifetime of the claimant and remain in the estate when the claimant dies. The discount rate does not take account of any appreciation of fixed assets that may benefit the claimant and/or the claimant's estate financially and may provide over-compensation, and *Roberts v Johnstone* calculations fall into disarray with a negative discount rate. The discount rate should reflect the expected real rate of return on invested funds and forecast rates of return on capital investments.

Q3: Please provide evidence as to how during settlement negotiations claimants are advised to invest lump sum awards of damages and the reasons for doing so.
As defendants we are not privy to financial advice provided to claimants.

The MDU has advocated since the early 2000s that robust evidence of the types of investment advice provided to claimants and evidence of whether they follow that advice and what they do with their award must form the basis of decisions made about the discount rate by the Lords Chancellor. We repeated this in our consultation responses on the discount rate in 2012 and 2013 and yet the recent decision taken by the Lord Chancellor was made in the absence of robust information, as this consultation document acknowledges by seeking such information after the event. In order to determine whether the sums awarded to claimants are fair and reasonable, those representing claimants must be required to provide evidence about how their clients are advised to invest their awards and what they do in practice.

Although the MDU has no evidence about the investment advice provided once an award has been agreed, there are publicly available sources of information about advice available to claimants. For example, Frenkel Topping provides financial advice to vulnerable people, including those who have received personal injury and clinical negligence settlements. Their investment brochure for such clients outlines their ethos and approach. There is no mention of specific financial instruments but general

explanations of how they attempt to protect the funds of their clients. There is no suggestion in the brochure that they advise clinical negligence claimants to invest their awards solely in ILGS. The suggestion is that they advise investment in a low-risk mixed portfolio:

> **'In an uncertain economic and investment environment, the Safety First portfolio range is designed to protect client funds from risk and potential loss via its volatility capping mechanism. The volatility capped process aims to protect our client's investments from dramatic market fluctuations at a risk level suited to their particular investment objective, embedding our research partner's Market Stress Indicator (MSI) fully in the process so as to pro-actively search for an early warning of market volatility, with the aim of avoiding the worst periods of negative market returns.'**

Firms that specialise in and derive fees from providing investment advice to claimants, especially those associated with claimants' lawyers, profess particular expertise in this area and should be required to explain their approach on behalf of their clients.

There are other useful sources of information. For example, it would be instructive for the MoJ to look at the investment advice and practice of institutional pension funds. They have a similar requirement to ensure there will be adequate funds available many years into the future, though they differ from personal injury claimants who, if they were so badly advised that their awards ran out, could still rely on all necessary health and social care to be provided by the state, as it is to all other patients with the same extent of injury or damage but who are unable to prove negligence.

We believe the MoJ should identify and seek information about investment advice and practice from other organisations and funds that have a fiduciary duty to ensure there are sufficient funds available for clients who may be considered risk averse, many years into the future. There are a number of organisations that could be approached, for example, the Association of Professional Financial Advisers, the Personal Finance Society and the Wealth Management Association.

Q4: Please provide evidence of how claimants actually invest their compensation and their reasons for doing so.

The MDU does not have evidence of how claimants are advised or how they invest their compensation. There is very little evidence available.

Of the limited evidence that is available publicly, a report produced for the MoJ on 29 October 2013 provided some evidence about claimants' investment behaviour and their use of state health and social care instead of or to supplement their award (p45):

> 'For a few claimants, however, the state provision of health services was preferable to the private sector. The two **claimants interviewed with spinal injuries reported being able to use the NHS** for spinal injury care alongside private physiotherapy.
>
> > *All spinal injury services are NHS and you can't get better privately.*
> > Claimant with spinal injuries, RTA
>
> Some of those who struggled to manage regular costs drew on state provision of care and therapy in preference to paying for services, even when this care was considered inferior to that available privately. These claimants typically reported **relying on the state benefits they were entitled to, and managing within their weekly budget rather than drawing on their lump sum**, which they wanted to preserve for their future needs. In one case, the mother of a claimant was beginning to replace private care with NHS care for her son, on the recommendation of her stockbroker, to save money. In our interviews this applied to three of the participants interviewed.
> *I feel if I am careful, I will be able to manage … living on benefits is key.* Claimant with head injuries, RTA'.

And a further example (pg 50-51):

> ***Case Illustration 1: David***
>
> … David initially had a case manager but felt that as he was already aware of many of the issues he faced as a spinal injury sufferer, it was 'pointless' in the long term: 'the assumption was, get others to do things because it's paid for, it's part of the lump sum'. He did however receive investment advice and opted for medium-risk investments. He still talks to his financial advisor regularly to tweak these investments according to his needs, and envisages making more drastic changes to

his investments as he reaches pensionable age and his financial situation becomes more difficult.

David has relatively few regular outgoing payments associated with his injury and feels confident about his financial situation in the future. He uses NHS spinal injury services as he feels the care he receives here could not be provided better privately...'

Case illustration 2 describes a claimant removing the award from ILGS to low-risk investments after having sought advice from an independent financial adviser.

While this research provided some insight into the practice of the few claimants who were interviewed, it cannot be taken as representative of what happens in practice. In order to inform decisions about the discount rate, MoJ needs a more robust evidence base.

Q5: Are claimants or other investors routinely advised to invest 100% of their capital in ILGS or any other asset class? Please explain your answer. What risks would this strategy involve and could these be addressed by pursuing a more diverse investment strategy?

We do not believe IFAs would advise investing 100% of a damages award in ILGS on the expectation they will be able to match their expected outgoing to cashflow. Indeed Jennifer Stone, director of the independent financial advisers Nestor, recently said so in a filmed discussion with barrister Andrew Axon. They were discussing the recent discount rate drop and she said her company never advised clients to invest 100% in ILGS (at 17mins 57 second on attached video interview).

The Law Lords' decision in *Wells v Wells* was no doubt influenced by the existence of an index-linked gilt market which calibrated their 3% decision. We believe the decision might be different in current market conditions where the cost of ILGS is not reasonable.

We have indicated in response to Q3 that investment advisers appear to advise a mixed portfolio which we support because:

- **Higher rates of return are achievable through mixed portfolios.**

- **ILGS are not risk free. The price is driven by the combination of 'pull to par' as the bond heads towards maturity and the real yields and price can fluctuate quite dramatically.**
- **A long term investment designed to provide for the injured person over 40 years or more, the fund to be exhausted at the end of that time, should be predicated on long term data and not a short term snapshot.**
- **The presumption that claimants will invest 100% in ILGS with a certain negative return, which defendants are expected to make good, is wholly unrealistic. Such an investment strategy would be highly imprudent.**

In practice a prudent risk averse investor is most likely to pursue a range of investment strategies and in aggregate will be more likely to be over-compensated under current law.

In order to understand the types of financial products and their probability of sufficiency for a claimant who is investing a damages award, we sought actuarial advice. Our advisers were asked to estimate probabilities that lump sums calculated on various sets of assumptions will be sufficient to meet a claimant's care costs for the remainder of their lifetime. Their methodology and findings are reproduced below. Insisting on a sufficiency probability of 80% (an expectation that 80% of claimants would be over-compensated and 20% under-compensated), a 100% equity portfolio could support a discount rate of 2.7% real (as opposed to -1.8%) and still have a higher sufficiency probability than ILGS. A 50% equity portfolio could support a discount rate of 1.5% without reducing this sufficiency probability.

Sufficiency Calculations

This note provides approximate calculations of the probability that a given fund and investment strategy, will be sufficient to provide an inflation-linked income for an individual's remaining life.

These calculations assume a geometric random walk model for investment returns and an (independent) exponential distribution for a claimant's future lifetime.

Probability of Sufficiency with an Index-Linked Gilt Portfolio

The strategy of 100% index linked gilts is sometimes described as risk-free. The "risk free" assessment applies only to the match to RPI and the low risk of government default. A claimant accepting a lump sum and investing 100% in index linked gilts is still exposed to several risks:

- Expected cash flows use an average future life. The actual date of death is unknown; if greater than the assumed average then the funds may be insufficient. In addition to the general randomness in date of death, there is also a risk that the actuarial average life is mis-stated.
- Index linked gilts are tied to the RPI (retail prices index) but costs of care are subject to different (higher or lower) inflationary pressures than retail prices.
- Cash flows from index linked gilts provide coupons every six months and a lump sum at maturity. To the extent that the gilt cash flows do not exactly match the incidence of care costs, assumptions must be made about the rate at which bonds are sold or coupons reinvested to meet the actual care costs. This problem is likely to be most significant when projected care costs extend beyond the longest dated traded ILG, currently 2068.
- Other risks may be considered smaller, such as government default risk (including the risk of political interference with the RPI calculation), changes in taxation, and uncertainty in investment management costs.

Our next step is to compare ILG portfolios to mixed portfolios, taking account of the first two risks in this list (uncertain longevity and inflation differences) as well as market risk.

Using Historic Returns to Estimate Possible Returns on Mixed Portfolios

The UK has 35 years of index linked gilt history. Bonds, treasury bills and equities have a much longer history.

The definitive text on historical returns is the book by Dimson, Marsh & Staunton (DMS). There are different ways to cut the data. Taking their aggregate world indices, the tabulated real returns (geometric mean) from 1900 to 2001 are (Table 34-1, page 311)

- T-bills 0.9% (standard deviation 4.7%)
- Bonds 1.2% (standard deviation 10.3%)
- Equities 5.8% (standard deviation 17.0%)

The yield differences are chiefly attributed to differences in risk, with equities more risky than bonds which in turn are riskier than T-bills.

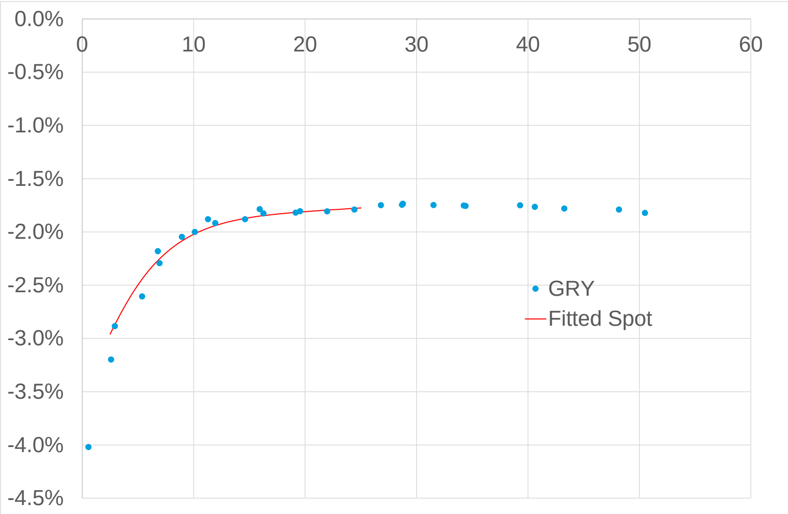
Index Linked Bond Yields

Historic bond real returns have varied from year to year. However, since the early 1980s it is possible to purchase index linked bonds whose real return is known on a hold-to-maturity basis. Therefore, although there has been a historic distribution of real returns with some mean and standard deviation, measured longitudinally (over time), for the future outcomes the relevant mean is the market real rate and the standard deviation is zero.

Real yields on index linked gilts have fallen dramatically since the initial launch of ILGS, particularly since the financial crisis in 2008. The chart below shows real yields from 1985 until April 2017 (continuously compounded, source: Bank of England).

The Current Yield Curve

This chart shows negative yields in recent years. The chart below shows index linked gilt yields as function of modified duration (a weighted average term that counts the coupons as well as the maturity), both for individual bonds (source: DMO) and the Bank of England's fitted curve, as at the end of April 2017. It can be seen that the negative yields persist at durations out to 50 years. These market yields show no evidence of any expected reversion to historic rates of real return within that time horizon.



Updating Risk Premium Assumptions

For portfolios looking forwards, the ILG component (at least) should be based on the current available yield for the relevant term and not on historic real return of low risk investments.

If the forecast real returns on ILGS are based on index linked gilt yields (and not on historic real returns) this raises the question of how to model returns on other assets such as equities.

We can analyse historic returns on risky assets as inflation + "low-risk" real return + risk premium.

The last two are the real return. Taking the "world" DMS data, we have

- Bond real return = 0.9% (low risk real) + 0.3% (bond risk premium)
- Equity real return = 0.9% (low risk real) + 4.9% (equity risk premium)

There are two possible options to adapt these to lower real returns, from -0.5% at the 10 year point to 0.25% at the long end.

- Assume the risk premium is unchanged, so that equity and bond real returns are lower than the past history. This would be consistent with low real returns caused by excess supply of funds and lack of profitable projects.
- Alternatively, it could be assumed that prospective real returns are unchanged, so that the risk premiums are higher than before. This is consistent with associating the falling index linked yields with an increase in investor risk aversion and a flight to quality.

Combining the Assumptions

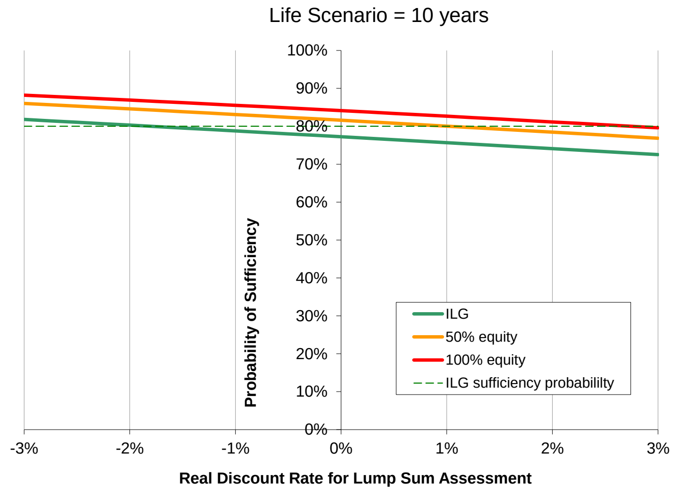
Here are some illustrative probability calculations for different portfolios based on the DMS data and current ILG yields.

- Specifically, for ILG yields a low-risk real return of -1.8% is assumed, equating roughly to the 15 year point of the April 2017 curve
- For equities, a risk premium of 4.9% is assumed, consistent with the historic risk premium from the DMS world data set. This implies a real return also of 3.1% as the low risk return is measured relative to ILGS for which we assume a real yield of -1.8%. We have made no deduction for investment management, taxes or advice costs.
- A 17% volatility for equities is assumed, consistent with the historic data. When modelling ILGS a 1% volatility in real returns is assumed to reflect that care costs are modelled with the ASHE index while ILGS are indexed to the RPI.
- In addition to ILGS a portfolio of 50% equities and 50% ILGS is included in the model. The volatility is assumed to be 9%, while the real return is based on an average real returns for ILG's and equities, allowing for the fact of rebalancing the portfolio regularly to 50% mix.

Longevity Assumptions

Claimants with mean future lifetimes of 5, 10, 20, 30 and 50 years have been used as illustrations. Exponential distribution for these lives has been assumed, that is, a constant force of mortality, with the scenario corresponding to the 80th percentile of that distribution. This is different from the general population in which the force of mortality rises with age, and the mortality pattern for individual claimants could take a variety of shapes depending on their medical condition. A constant force of mortality could arise if deaths are dominated by a steady state of ill health related to the accident for which compensation is sought.

The results for the 10 year example are shown below:



Commentary on the 10-Year Case

With 100% in ILGS and discounting at -1.8%, the probability of covering all projected care costs is close to the assumed 80% confidence level for the lifetime scenario.

Moving the portfolio into equities, keeping the lump sum the same, has a beneficial effect on the probability of sufficiency. Moving to equities has two effects. First, there will be some scenarios where claimants outlive their life expectation but are still able to fund full care costs because of favourable equity returns. On the other hand, there will be scenarios where the claimant dies sooner than expected but still runs out of money because of low or negative investment returns. In probability, the former outweigh the latter, as allowing a longer period for comparison favours the equity market.

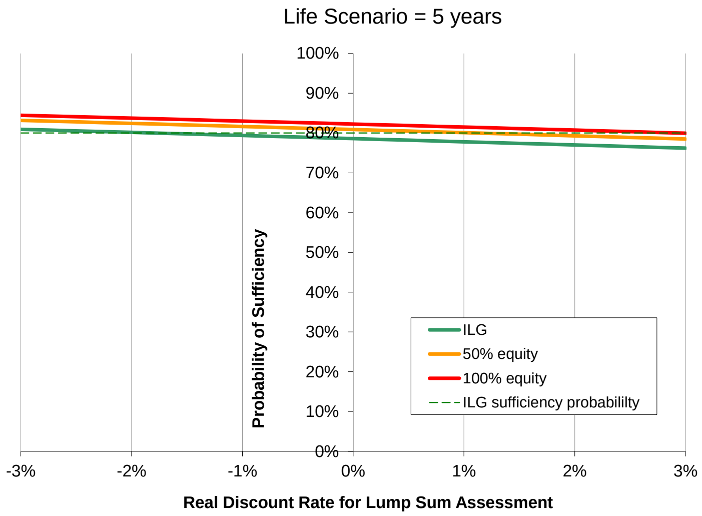
Supportable Discount Rates for Risky Portfolios

Instead of keeping the lump sum the same and watching the sufficiency probability, the calculation can be performed in reverse to consider how much increase in discount rate (lower lump sum) could be supported without reducing the probability of sufficiency. It can be seen, following the dashed line, that a 100% equity portfolio could support a discount rate of 2.7% real (as opposed to -1.8%) and still have a higher sufficiency probability than ILGS. A 50% equity portfolio could support a more modest real discount rate of 1.5% without reducing the sufficiency probability.

Note that the proposed addition to the discount rate is not the same as the expected return on the portfolio. For example, with 100% equity and an expected real return of 3.1%, a discount rate of 2.7% (and not 3.1%) can be supported. This arises because it is reliant on a sufficiency probability of 80%, rather than a 50/50 chance. The volatility of equity returns has some effect to reduce the sufficiency probability, but this is outweighed by the beneficial effect of the equity risk premium.

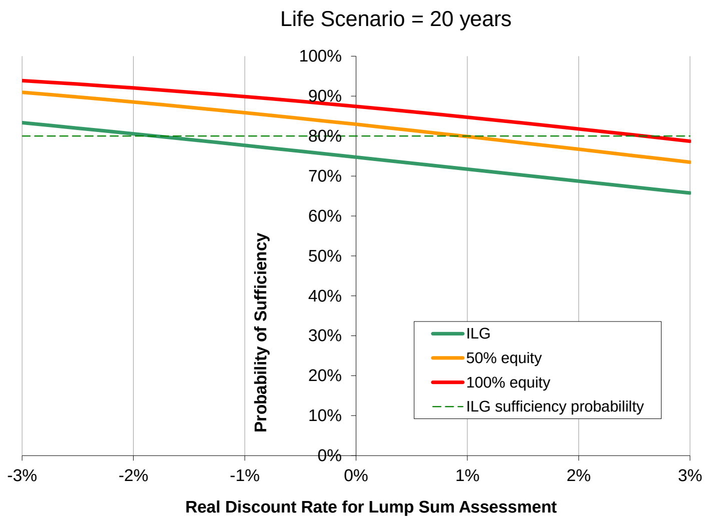
Results for 5 Year Lifetime

The corresponding chart for a 5 year lifetime scenario is shown below:



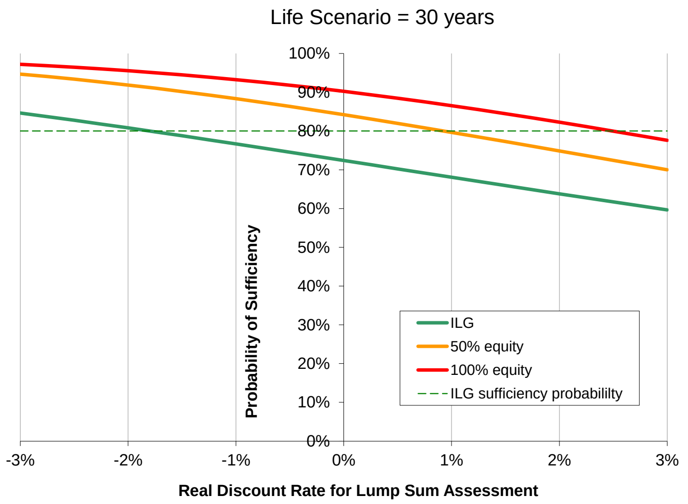
Results for 20 Year Lifetime

The corresponding chart for a 20 year lifetime scenario is shown below:



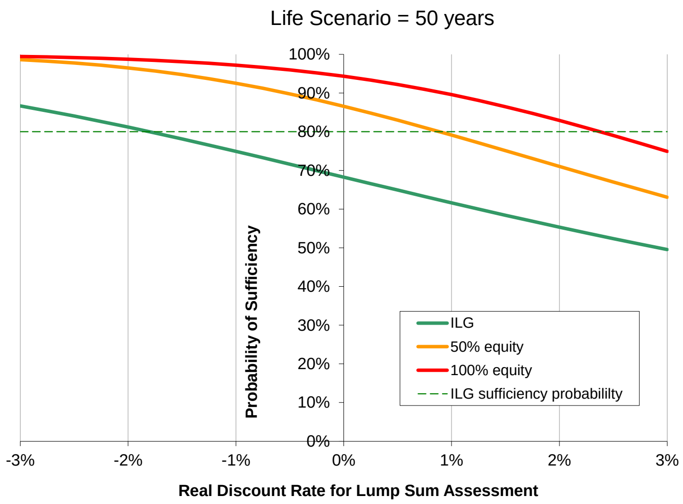
Results for 30 Year Lifetime

The corresponding chart for a 30 year lifetime scenario is shown over the page:



Results for 50 Year Lifetime

The corresponding chart for a 50 year lifetime scenario is shown below:



Simplifying Assumptions

These illustrative calculations make a large number of simplifying assumptions; including the following:

- Real returns and the ratio of ASHE to RPI indices are assumed to follow geometric random walks. This in particular excludes sudden jumps or time-varying parameters.
- Historic data has been used to forecast future risk premiums. However, there are practical problems in obtain accurate data for the earlier part of the 20^{th} century, and the selection of countries excludes those with incomplete histories, such as Russia where equity investors lost everything in 1917. We are reliant on the DMS methodology for these calculations.
- The 1% volatility of the ASHE index relative to CPI is a placeholder; further econometric work would be needed to confirm this is reasonable.
- More generally, there is an assumption that the past returns are a guide to future returns.
- No deduction to rates of return has been made in order to allow for tax, investment management expenses or the cost of financial advice.
- It is assumed that court awards are based on conservative estimates of future life expectancy. The mortality tables are illustrative only and no claim is made that these are valid for a specific individual or group of individuals.

Q6: Are there cases where PPOs are not and could not be made available? Are there cases where a PPO could be available but a PPO is offered and refused or sought and refused? Please provide evidence of the reasons for this and the cases where this occurs.

The MDU is unable to offer periodical payments because the MDU is not an insurance company. It is a discretionary mutual indemnity organisation and all benefits of membership rest at the absolute discretion of the Board of Management. MDU assistance is not covered under the Financial Services Compensation Scheme (FSCS) and does not satisfy the continuity of payment criteria as set out in Section 2 (4) of the Damages Act.

In any event, in the majority of cases involving serious injury most non-motor insurers will not be able to offer periodical payments because although the policies will be covered

under the FSCS, the cumulative cost of periodical payments, when compound wage inflation is taken into account over a claimant's lifetime together with the lump sum element of the claim, will invariably exceed the limit of indemnity. Periodical payments may also not be feasible in cases where damages have been reduced, for example, due to contributory negligence.

Only government departments or government backed organisations such as NHSR and motor insurers (motor policies carry unlimited liability and are 100% covered under the FSCS) satisfy the continuity of payment criteria. However, the MDU is not aware of any studies that have been undertaken on the cost/benefit to society of periodical payments, which include substantial administrative costs, compared with lump sum settlements.

We are not aware of any PPO being imposed on a claimant and would consider this unreasonable. Whenever feasible, claimants need to be in a position to decide what type of award would best meet their future requirements or those of the person on whose behalf the settlement is agreed.

Q7: Please provide evidence as to the reasons why claimants choose either a lump sum or a PPO, including where both a lump sum and a PPO are included in a settlement.
We do not know how claimants are advised but we do know they receive advice during the settlement process to help them to determine the most appropriate type of award for their particular wishes and requirement.

It must be appreciated that all claims involving PPOs have a lump sum element to them. It is usually only the cost of care and case management that is settled by way of PPOs. The lump sum element (accommodation, accommodation adaptation and running costs, loss of earnings/pension, aids and equipment, therapies, prosthetics, medical expenses, vehicle costs, travel expenses, DIY/gardening, additional holiday costs etc) in serious cases typically runs well into seven figures and the discount rate has a significant impact on these claims too.

The MDU's experience is that claimants with serious injuries pursuing claims against NHS Resolution prefer PPOs and indeed that is NHSR's preferred model. However, some competent adult claimants may prefer the 'clean break' that a lump sum settlement offers or indeed the flexibility of a lump sum that they can invest as they wish.

In some cases where the settlement is discounted to reflect liability risks, or there is a reduction for contributory negligence, claimants may prefer the flexibility of a lump sum.

Q8: How has the number of PPOs changed over time? What has driven this? What types of claims are most likely to settle via a PPO?
Evidence suggests there has been a decline in the use of PPOs in recent years in some areas of insurance. We suggest the MoJ seeks information from expert bodies such as the Association of British Insurers, and the Institute and Faculty of Actuaries that has a working party on PPOs. We refer the MoJ to the IFOA PPO Working Party update presented at GIRO 2016 on 22 September 2016.

Q9: Do claimants receive investment advice about lump sums, PPOs and combinations of the two? If so, is the advice adequate? If not, how do you think the situation could be improved? Please provide evidence in support of your views.
As at 7 above, we know because defendants pay for such costs at settlement, that claimants receive expert financial advice to help them to decide on the most appropriate type of award for their particular wishes and requirements.

Q10: Do you consider that the present law on how the discount rate is set should be changed? If so, please say how and give reasons.
Yes – we have already given many of our reasons in response to the first question.
It is illogical and damaging for the legal requirement to be confined to the, in practice unrealistic, aim of ensuring the claimant receives neither more nor less than 'full compensation', disregarding the defendant completely. The damaging financial effects of a decrease in the discount rate on defendants and society more widely cannot and should not be ignored. The intended benefit to the claimant must be balanced against the wider public interest. The number of successful claimants is very small in proportion to the

numbers of other citizens who will be affected adversely directly or indirectly by the fall in the discount rate. Their interests must also be considered and weighed in the balance. This includes users of public services such as the NHS, anyone who buys insurance (by choice or because the law requires it) and other public bodies that must pay damages as defendants, and businesses more widely. The fall in the discount rate has had a profound effect that cannot be ignored. There is now a substantial body of evidence attesting to the financial difficulties the recent 3.25% decrease in the discount rate has caused in all these areas, and no doubt many others. The law must take the impact on defendants and the wider public into account.

Parliament, in making law governing the assessment of damages for injured persons must, in the words of Lord Hutton, 'be in a position to balance the many social, financial and economic factors which would have to be considered if such a change were contemplated.' We agree.

We have explained in response to Q1 the reasons why accountability for taking the decision on the discount rate should not rest with just one person and that, even if the decision is not a collective one, there should be a legal duty for the decision-maker to consult specified others and in a manner and to the extent specified in law.

There must be a legal requirement for the decision-maker to be able to provide a sound evidence base for the decision, especially with respect to how claimants invest and spend their money. This could in part be provided by a legal requirement to create a panel of independent advisers. While such a panel must have representatives from claimants and defendants, it should be composed largely of independent experts with relevant skill sets (see answers to Q27). The panel should collectively provide the decision-maker with robust evidence on which to base decisions and/or provide expert opinions on other evidence submitted to the decision-maker.

The panel should also be able to provide advice, or to assist the decision-maker to evaluate evidence provided, on the financial climate and its effect on all parties, as well as

on the effect of a discount rate change on claimants and defendants, and on the wider public interest.

Q11: If you think the law should be changed, do you agree with the suggested principles for setting the rate and that they will lead to full compensation (not under or over compensation)? Please give reasons.

The principles as set out in paragraph 36 appear reasonable but they are not sufficient. For example, there should be an additional principle that the decision-maker must consider all relevant factors and especially the prevailing long-term economic climate and the impact on all affected parties, which is not just limited to defendants.

The principal problem with the setting of the discount rate is not just the principle of full compensation, which in practice can never be realistically achieved. There will always be over or under-compensation because assumptions are made about the future that are not likely to be accurate. There is also the fact that assumptions are being made without a robust evidence base and with disregard for any potential adverse impact on public finances and on the economy more widely. A fundamental principle should be that any decision on the discount rate should be a balancing act between the different interests and based on a robust evidence base (as per the Court of Appeal in *Wells v Wells*).

Q12: Do you consider that for the purposes of setting the discount rate the assumed investment risk profile of the claimant should be assumed to be:

(a) Very risk averse or "risk free" (Wells v Wells)

No. This is unrealistic. No investment is risk free and we don't think this is what happens in practice.

(b) Low risk (a mixed portfolio balancing low risk investments).

This would depend on what investments are considered to be lower risk and the MoJ need to seek evidence, from investors specialising in advising this type of client, about the investment vehicles they recommend and that are used.

(c) An ordinary prudent investor

There will be some similarity between a claimant's risk appetite and that of an ordinary prudent investor who invests money with the aim of ensuring there will be sufficient funds available at a pre-determined date in future. An example is retirement planning, but omitting the aim of maintaining a residual estate to pass on to beneficiaries, as damages should be used for the care of the injured claimant and not to enrich any beneficiary of the estate. However, the outlook for ordinary prudent investors could be considerably bleaker if investments fail because they may lose all their income (other than a state pension – if they are eligible) and their home. With injured claimants, the award is invested largely to provide private future care. If it were to run out (and we have seen no evidence of insufficiency in lump sum awards at a 2.5% discount rate) they would not be left without appropriate care and treatment and could rely on the NHS and local authority care alone. Indeed, some of the responses to the 2013 research suggests claimants in receipt of awards predicated on private care were continuing to use NHS care because it was better, or as a supplement to their private care.

(d) Other.

This is a very specific group of investors with specific needs. Rather than base discount rate policy on a series of assumptions about what claimants do or might do, it would be preferable to collect robust evidence in order to inform decisions made about their risk appetite and what they can be reasonably be expected to do with an award.

To use an example from another jurisdiction, in Canada the discount rate is intended to reflect the expected real rate of return on invested damages, awards and forecasted rates of return on capital investments. There are four relevant cases in the Supreme Court of Canada, *Lewis v Todd*; *Andrews v Grand and Toy Alberta Ltd*; *Townsend v Kroppmanns* and *Archibald v Nesting*. The courts in Canada described the appropriate rate of return on investment as the 'income generated from high grade investments of a long term duration'. While the 'plaintiff' should not be assumed to be a sophisticated investor, the common law in Canada also recognises that investment management will occur where large capital sums are awarded, that is the claimant is expected to take expert financial advice. While prudent investors in the past may have gone for index linked government stocks, a prudent investment now includes some diversified portfolio containing equity

investments which could be indexed to the FTSE or a world stock market index. It doesn't require a greater degree of sophistication to invest in an indexed equity fund rather than real return bonds.

Q13: Should the availability of Periodical Payment Orders affect the discount rate? If so, please give reasons. In particular:
Should refusal to take a PPO be taken as grounds for assuming a higher risk appetite? If so, how big a difference should this make to the discount rate?

No. Claimants no doubt have good reasons for the decisions they make about the type of award they wish to receive. No reliable assumptions could be made about their risk appetite on the basis of whether they are seeking a lump sum or a PPO. They should be allowed, wherever feasible, to choose the method that best suits their wishes and requirements.

Should this assumption apply in cases where a secure PPO is not available?
We have explained at Q6 that it is wrong to assume PPOs are or could be always available. There are many legitimate circumstances in which payment of a PPO will never be secure. These were foreseen in the Courts Act 2003 and the fact that some defendants will never be in a position to provide a secure PPO is unlikely to change. Only PPOs arranged by defendants paying claims on a 'pay as you go' basis, underwritten by the taxpayer, would ever be completely secure.

Q14: Do you agree that the discount rate should be set on the basis that claimants who opt for a lump sum over a PPO should be assumed to be willing to take some risk? If so, how much risk do you think the claimant should be deemed to have accepted? Please also indicate if you consider that any such assumption should apply even if a secure PPO is not available. Please give reasons.
We do not – please see above. Claimants may have a number of good reasons for seeking a lump sum award and no inferences can be drawn about their risk appetite.

Q15: Do you consider that different rates should be set for different cases? Please give reasons. If so please indicate the categories that you think should be created.

The recent 3.25% decrease in the discount rate has had a directly adverse effect on the funding of NHS negligence claims in the primary and secondary sectors and will require substantial funds (£5.9bn for just 3 years at current estimates, but this sum is likely to rise by 10% next year and in subsequent years as a result of claims inflation) to meet the increased liabilities. This has the potential to divert NHS funding away from crucial areas of patient care and treatment and, if no financial assistance is forthcoming for GPs, to push many of them out of healthcare entirely and to deter new doctors from entering this essential area of practice. There is no doubt a similar increase in the liabilities of other public services in respect of personal injury claims and in respect of public and employers' liability claims (which also apply within the NHS).

Taken together, the immediate and adverse impact of the discount rate decrease on public services suggests grounds for considering whether there might be a special case to be made to create a separate category for those services that carry a risk of personal injury but which provide essential public services.

In the introduction pages of the consultation document there are some paragraphs examining how the discount rate operates in other jurisdictions. The way in which the rate is set in Ontario bears further examination, especially for categories of claims with long tails. This has two prescribed rates – one of 2.5% for future losses over more than 15 years and one for losses over shorter periods based on real return - that would have the benefit of addressing concerns about investing in the short-term in vehicles such as equities, and provide for dips in the market.

Q16: Please also indicate in relation to the categories you have chosen whether there are any special factors that should be taken into account in setting the rate for that category.
In respect of public services there would need to be balancing act between the needs of claimants and the far larger body of citizens who rely on public services. Consideration would have to be given to the extent that essential public services (and their users) would suffer because of financial restrictions imposed because of additional and unaffordable liabilities created by a discount rate fall.

Q17: Should the court retain a power to apply a different rate from the specified rate if persuaded by one of the parties that it would be more appropriate to do so? Please give reasons.

No. As far as we are aware, the UK courts have not applied a different rate, though they have been asked to do so. We take this as an indication that the judiciary may agree that such a decision should be taken in a manner that considers the wider implications, and should not be made in respect of the particular circumstances of individual cases before the courts.

Claimants and defendants need to have certainty, particularly in the long-tail situations that often arise in personal injury. All parties need to know what rate will apply and for there to be a clear rationale for that rate. Much of our consultation response has focused on the adverse financial impact on the public and private sectors as a result of the recent massive decrease in the discount rate and we have suggested a number of ways in which this can be reduced and avoided in future. To allow the courts to apply a different rate would undermine all the work we believe must be done to ensure that in future the discount rate is set fairly and transparently and with due regard to all the factors that need to be taken into account. The setting of a discount rate has far-reaching repercussions and any decision about it should be reserved for one, agreed, decision-maker (person or organisation) following a specific set of procedures and with specialist expert advice and input, supported by robust, factual evidence.

Q18: If the court should have power to apply a different rate, what principles should apply to its exercise?

We do not think the courts should retain such a power. They have not so far used it and there are good public policy reasons why the decision should be reserved for one, specified, decision-maker.

Q19: Do you consider that there are any specific points of methodology that should be mandatory? Please give details and reasons for your choice.

It is likely there are specific points of methodology that should be mandatory but the position is not clear enough to specify them yet. There are other, higher level issues that

need to be addressed first – such as who should be the decision-maker/rate setter; what the process should be for seeking evidence, comments and input and from whom; should there be an expert panel and what type of experts should be appointed and should any of the parties be represented on it? Once these matters have been addressed, it should be for the decision-maker/body, having sought advice from the expert panel to propose a methodology, which will need to be put out for consultation.

Q20: Do you agree that the law should be changed so that the discount rate has to be reviewed on occasions specified in legislation rather than leaving the timing of the review to the rate setter? If not, please give reasons.
We agree the law should give clear guidance as to the triggers for a review of the discount rate. While the law may specify the triggers to be applied, and could decide that time should be one of those triggers, we do not believe it is necessary for primary legislation to specify timing of the review.

The key principle that must be applied to setting and reviewing the discount rate is certainty so that any change should be predictable. Claimants need to know what they can expect and be in a position to take appropriate advice, and defendants need to be able to anticipate any change in the discount rate and to plan for it so that when it is introduced it happens in a way that causes least disruption to their business.

Q21: Should those occasions be fixed or minimum periods of time? If so, should the fixed or minimum periods be one, three, five, ten or other (please specify) year periods? Please give reasons.
A review of the discount rate is likely to create expectations and, while the review itself won't change the rate, its outcome will determine what should happen. For this reason we believe a review should only be undertaken in circumstances where it is necessary. This suggests that setting a fixed timescale for review may not be the best approach. Further work needs to be undertaken in order to identify what factors should be triggers for a review. It may be decided that specific economic factors should be the sole trigger, or that they should be considered also in the context of a specific time period.

Q22: When in the year do you think the review should take effect? Please give

If it is decided that reviews should be set to take place at fixed time period, we suggest that December, the end of the year, would be the most appropriate.

Q23: Do you agree that the rate should be reviewed at intervals determined by the movement of relevant investment returns? If so, should this be in addition to timed intervals or instead of them? What do you think the degree of deviation should trigger the review?

We agree that reviews of the rate may need to be determined by analysis of the movement of relevant investment returns. We do not think this should be the only trigger. If a time factor is to be a factor then, an agreed and sufficiently-long time period should be considered in the interests of creating as much certainty as possible and to allow for proper planning by all parties.

Q24: Do you agree that there should be a power to set new triggers for when the rate should be reviewed? If not, please give reasons.

We have suggested above that further work must be done in order to identify the appropriate triggers for a review of the discount rate. We believe this should be undertaken by the expert panel who will all be able to contribute their particular expertise to the process and to advise the decision-maker. Once the panel has made a recommendation about the appropriate triggers, this should be circulated for consultation among stakeholders.

Once agreed, no new triggers should be set without an adequate rationale, appropriate consultation and a sufficient time before introduction to allow those affected to prepare.

Q25: Do you consider that there should be transitional provisions when a new rate is commenced? If so, please specify what they should be and give reasons.

There needs to be certainty and predictability and there also need to be clear transitional arrangements in order to avoid any adverse consequences of the introduction of any change. For example, as soon as the Lord Chancellor made her statement on 7 December, we noticed a change in the behaviour of claimants' solicitors who began immediately to

advise their clients not to accept settlement of any cases, or who sought to agree settlement but only if it included an opportunity to review the agreed sum once the new discount rate was announced. Such behaviour was no doubt common for all personal injury claims affected ahead of the actual 20 March rate change. It is disruptive and has adverse financial consequences in terms of cash flow and funding for defendants. When the law is changed, it should contain robust safeguards to protect against such behaviour within the transitional arrangements. Applying the new rate only to incidents that occurred after the rate change would achieve this.

Discount rate drops should never have retrospective effect. To explain why, we take the example of medical practitioners who are required by [their regulator the GMC] to have 'adequate and appropriate insurance or indemnity in place when they start to practise medicine in the UK' with a further requirement that 'Patients you saw whilst working as a doctor should not be left without a means of being compensated irrespective of whether the claim is brought while you are practising or after you have retired or have stopped working.' To meet this requirement the medical defence organisations (MDOs) provide indemnity to GP and consultant members on an occurrence basis, recognising that claims can be brought many years after the incident leading to the claim. A discount rate drop with retrospective effect is particularly destructive for these doctors. It also jeopardises patient compensation and patient access to healthcare by pushing claims awards to astronomically high levels which results in subscriptions at levels that many GPs may not be able to afford. And this is against a background, even before the discount rate drop, of claims inflation that sees compensation awards doubling in size every 7 years.

Q26: Do you consider that the discount rate should be set by:

a) A panel of independent experts? If so, please indicate how the panel should be made up.

Yes. We believe there should be a panel of experts who understand the legal and financial repercussions of the discount rate. The panel must include actuarial, investment management and wider financial/economic expertise. They must be chosen through a transparent procedure. While all steps should be taken to ensure those who provide

financial and economic advice are demonstrably independent, the panel must also contain representatives from the parties affected by the discount rate – claimant and defendant.

b) A panel of independent experts subject to agreement of another person? If so, on what terms and whom?

In order to demonstrate independence, the panel must not be chosen by an individual but by a process that guarantees independence in as far as it is possible given the panel must include representatives from claimants and defendants.

Would your answers to the questions above about a panel differ depending on the extent of the discretion given to the panel? If so, please give details

No. The panel should be advisory and it should be for the decision-maker/rate setter to decide. However, as we have explained above, there must be a set procedure that must include consultation on any proposal to change the rate.

c) The Lord Chancellor and her counterparts in Scotland or another nominated person following advice from an independent expert panel? If so, on what terms?

No. Any decision to change the discount rate has wide-ranging implications and is in effect a financial, rather than a legal decision. It should not be taken by the Lord Chancellor and, whoever takes the decision must follow a procedure which includes consultation. We do not know if the expert panel would be best placed to advise on an appropriate decision-maker. This would depend on its constitution. The decision-maker/body must be accountable directly to government.

d) The Lord Chancellor and her counterparts in Scotland as at present?

No – please see our previous answers.

e) Someone else? If so, please give details.

The decision-maker/body must be a person who fully understand the financial as well as legal implications of a discount rate change and must be held directly accountable by the government.

Q27: Do you consider that the current law relating to PPOs is satisfactory and does not require change? Please give reasons.
We have seen no evidence to suggest the law in respect of PPOs needs to change.

Q28: Do you consider that the current law relating to PPOs requires clarification as to when the court should award a PPO? If so, what clarification do you consider necessary and how would you promulgate it?
We are not aware that courts have any difficulty in deciding whether a PPO is appropriate. A large part of the court's decision must rest on the acceptability of a PPO to the claimant and the feasibility of constructing a PPO in the individual case. For example, it would be inappropriate for a court to force a PPO on an unwilling claimant and we do not know of any case where this has happened.

Q29: Do you consider that the current law relating to PPOs should be changed by creating a presumption that if a secure PPO is available it should be awarded by the court? If so, how should the presumption be applied and on what grounds could it be rebutted?
No. The claimant will have taken advice about the most appropriate method for receiving damages given his or her particular circumstances. The court should not be able to force a PPO on a claimant who has been advised that a PPO is not appropriate for that claimant's circumstances.

Q30: Do you consider that the current law relating to PPOs should be changed by requiring the court to order a PPO if a secure PPO is available? If so, what conditions should apply?
No. Please see above.

Q31: Do you consider that the cost of providing PPOs could be reduced? If so, how.
We do not provide PPOs but understand there are ways that might reduce the cost, for example pooling schemes. Another possibility might be tax exemption for earnings on assets used to fund PPOS. These need further exploration and it is possible such work could be undertaken by the expert panel.

Q32: Please provide details of any costs and benefits that you anticipate would arise as a result of any of the approaches described above.

Q33: Please provide any evidence you may have as to the use or expected use of PPOs in the light of the change in the rate and more generally.

We anticipate there will be far fewer PPOs at a discount rate of -0.75%. As a rate of -0.75% will over-compensate the prudent investor with a mixed portfolio, claimants will be more likely to choose a lump sum.

Impact Assessment

Q34: Do you agree with the impact assessment that accompanies this consultation paper? If not, please give reasons and evidence to support your conclusions.

Equalities Statement

Q35: Do you think we have correctly identified the range and extent of effects of these proposals on those with protected characteristics under the Equality Act 2010?

Q36: If not, are you aware of any evidence that we have not considered as part of our equality analysis? Please supply the evidence. What is the effect of this evidence on our proposals?

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