

Title: <b>Damages Act 1996 s1 – The discount rate: [Review of legal parameters]</b>	<b>Impact Assessment (IA)</b>
IA No: MOJ171	Date: 02/10/2012
Lead department or agency: <b>Ministry of Justice (MoJ)</b>	Stage: Consultation
Other departments or agencies:	Source of intervention: Domestic
	Type of measure: Primary Legislation
	Contact for enquiries: Paul Hughes Tel: 020 3334 3198

### **Summary: Intervention and Options**

**RPC Opinion: Amber**

Cost of Preferred (or more likely) Option				
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2009 prices)	In scope of One-In, Measure qualifies as One-Out?	
NQ	NQ	NQ	No	NA

#### **What is the problem under consideration? Why is government intervention necessary?**

Under section 1 of the Damages Act 1996 a discount rate is applied in personal injury cases to convert a stream of damages for future costs and losses into a lump sum payment (which can then be invested to generate a flow of future payments). In England and Wales, the rate is set by the Lord Chancellor for England and Wales. The rate for Northern Ireland is set by the Department of Justice and for Scotland by Scottish Ministers. In all cases the rate is set in accordance with section 1 of the Damages Act 1996. In England and Wales and Northern Ireland, the rate was last set in 2001, principally by reference to the three year gross redemption yield of Index Linked Gilts (ILGS). The rate was last set by the Scottish Ministers in 2002 on the same basis. There are concerns that this rate and/or the legal parameters used to set it may no longer be appropriate. Government intervention would be required to change the rate and the legal parameters used to set it. The current discount rate is 2.5% in real terms.

#### **What are the policy objectives and the intended effects?**

The Lord Chancellor and his counterparts in Scotland and Northern Ireland are under a duty to set an appropriate discount rate. The policy objective is to select and apply legal parameters, including assumptions around investments, that will produce a discount rate that is accurate so that, so far as possible, personal injury claimants are not under-compensated or over-compensated by receiving payment for their future losses and expenses in the form of a lump sum.

#### **What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

The two main policy options that are being considered are:

1. Change the parameters used to set the discount rate to reflect a mixed portfolio of financial assets rather than ILGS alone. This may lead to:
  - 1A. A discount rate greater than 2.5% (in real terms) or;
  - 1B. A discount rate lower than 2.5% (in real terms) depending on how the portfolio is defined.
2. Encourage greater use of periodical payment orders. For Scotland, consideration of this option is limited as periodical payment orders can only be made with consent of the parties involved.

At this stage the Ministry of Justice, the Scottish Government and the Department of Justice do not have a preferred option.

#### **Will the policy be reviewed? It will be reviewed. If applicable, set review date: 06/2018**

Does implementation go beyond minimum EU requirements?	N/A			
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	Micro Yes	< 20 Yes	Small Yes	Medium Yes
What is the CO <sub>2</sub> equivalent change in greenhouse gas emissions? (Million tonnes CO <sub>2</sub> equivalent)	Traded:			Non-traded:

*I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.*

Signed by the responsible Minister:

Date:

# Summary: Analysis and Evidence

# Policy Option 1A

**Description:** OPTION 1A: Change the parameters used to set the discount rate to reflect a mixed portfolio of financial assets resulting in a discount rate higher than 2.5% (in real terms)

## FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate: NQ

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low				
High				
Best Estimate	NQ		NQ	NQ

### Description and scale of key monetised costs by 'main affected groups'

The costs of this proposal are not quantifiable. A quantitative assessment would require specific data on the quantum and profile of compensation payments which is not currently available. MoJ, the Scottish Government and the Department of Justice are seeking to improve the evidence base through the consultation to which this IA relates and further research.

### Other key non-monetised costs by 'main affected groups'

An increase in the discount rate from 2.5% (real) would result in smaller lump sum compensation payments which would represent a cost to claimants. Some claimants with a low appetite for risk may also face increased costs associated with volatility of investments or lower returns depending on their investment behaviour. The Ministry of Justice, the Scottish Government and the Department of Justice may face some administrative costs if setting the discount rate to reflect a mixed portfolio is more complicated than setting it to reflect gilts.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low				
High				
Best Estimate	NQ		NQ	NQ

### Description and scale of key monetised benefits by 'main affected groups'

The costs of this proposal are not quantifiable. A quantitative assessment would require specific data on the quantum and profile of compensation payments which is not currently available. MoJ, the Scottish Government and the Department of Justice are seeking to improve the evidence base through the consultation to which this IA relates and further research.

### Other key non-monetised benefits by 'main affected groups'

Defendants would benefit from smaller lump sum payments. Defendants would include public sector bodies (for example, the NHS) and insurers and, in the case of insurers, this reduction in costs may be passed on to consumers in the form of lower insurance premiums although this would be a second round impact of this proposal. There may be benefits to wider society in terms of equity (fairness) if this proposal reduces the level of over-compensation.

### Key assumptions/sensitivities/risks

It is assumed that the discount rate set under option 1 would reflect a reasonable rate of return achievable for the typical personal injury claimant and under option 1A the discount rate would be greater than 2.5% in real terms. It is assumed that claimants vary in their risk appetites and investment behaviour and that there is no change in the volume of personal injury cases and periodical payments. It is assumed that there is no change in the costs of reaching a settlement.

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: NQ	Benefits: NQ	Net: NQ	No	Na

# Summary: Analysis and Evidence

# Policy Option 1B

**Description:** OPTION 1B: Change the parameters used to set the discount rate to reflect a mixed portfolio of financial assets resulting in a discount rate lower than 2.5% (in real terms)

## FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate: NQ

COSTS (£m)		Total Transition (Constant Price)	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Years	Years			
Low				
High				
Best Estimate	NQ		NQ	NQ

### Description and scale of key monetised costs by 'main affected groups'

The costs of this proposal are not quantifiable. A quantitative assessment would require specific data on the quantum and profile of compensation payments which is not currently available. MoJ, the Scottish Government and the Department of Justice are seeking to improve the evidence base through the consultation to which this IA relates and further research.

### Other key non-monetised costs by 'main affected groups'

A decrease in the discount rate would result in larger lump sum compensation payments which would represent a cost to defendants. For insurers these costs may be passed on to consumers through higher insurance premiums although this would be a second round impact of this proposal.

The Ministry of Justice, the Scottish Government and the Department of Justice may face some administrative costs if setting the discount rate to reflect a mixed portfolio is more complicated than setting it to reflect returns on index linked gilts.

BENEFITS (£m)		Total Transition (Constant Price)	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Years	Years			
Low				
High				
Best Estimate	NQ		NQ	NQ

### Description and scale of key monetised benefits by 'main affected groups'

The costs of this proposal are not quantifiable. A quantitative assessment would require specific data on the quantum and profile of compensation payments which is not currently available. MoJ, the Scottish Government and the Department of Justice are seeking to improve the evidence base through the consultation to which this IA relates and further research.

### Other key non-monetised benefits by 'main affected groups'

Claimants would benefit from larger lump sum compensation payments. Some claimants with a low appetite for risk may benefit further as they could generate the same stream of income from less risky assets than they might otherwise have chosen before the reduction in the discount rate.

There may be benefits to wider society in terms of equity (fairness) if this proposal reduces the level of over-compensation.

### Key assumptions/sensitivities/risks

### Discount rate (%)

It is assumed that the discount rate set under option 1 would reflect a reasonable rate of return achievable for the typical personal injury claimant and under option 1B the discount rate would be less than 2.5% in real terms. It is assumed that claimants vary in their risk appetites and investment behaviour and that there is no change in the volume of personal injury cases and periodical payments. It is assumed that there is no change in the costs of reaching a settlement.

## BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs:	Benefits:	Net:	No	NA

# Summary: Analysis and Evidence

# Policy Option 2

**Description:** Encourage greater use of periodical payments

## FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate: NQ

COSTS (£m)		Total Transition (Constant Price)	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Years	Years			
Low				
High				
Best Estimate	NQ		NQ	NQ

### Description and scale of key monetised costs by 'main affected groups'

The costs of this proposal are not quantifiable. A quantitative assessment would require specific data on the quantum and profile of compensation payments which is not currently available. MoJ, the Scottish Government and the Department of Justice are seeking to improve the evidence base through the consultation to which this IA relates and further research.

### Other key non-monetised costs by 'main affected groups'

Greater use of periodical payments may lead to costs to claimants due to a lack of flexibility around when they are able to spend and invest their compensation award. Claimants who would otherwise have invested their lump sum and gained returns greater than the discount rate would face a cost under periodical payments. Claimants and their relatives may also face costs if claimants die earlier than expected as there would be no legacy available when periodical payments stop, this would benefit defendants although overall this impact is expected to be neutral. There may be administrative costs to both claimants and defendants associated with annual payments.

BENEFITS (£m)	Total Transition (Constant Price)	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Years	Years		
Low			
High			
Best Estimate	NQ		NQ

### Description and scale of key monetised benefits by 'main affected groups'

The costs of this proposal are not quantifiable. A quantitative assessment would require specific data on the quantum and profile of compensation payments which is not currently available. MoJ the Scottish Government and the Department of Justice are seeking to improve the evidence base through the consultation to which this IA relates and further research.

### Other key non-monetised benefits by 'main affected groups'

Claimants would benefit from increased certainty as payments would be guaranteed every year. Claimants would no longer have to administer their investments or face investment risks under this proposal. Claimants who would otherwise have invested their lump sum and gained returns lower than the discount rate would benefit under periodical payments. Defendants would have more funds available upfront and would benefit if they are able to bear investment risks and management expenses at lower cost than they would pay claimants as part of their settlement. There may be benefits to wider society if this proposal increases equity (fairness).

Key assumptions/sensitivities/risks	Discount rate (%)
<p>It is assumed that compensation awards are equivalent, insofar as they represent full compensation, under periodical payments and lump sum payments. It is assumed that claimants vary in their risk appetites and that, on average, defendants have a risk appetite greater than implied by the discount rate. It is assumed that there would be no change to the volume of personal injury claims or level of compensation awards under this proposal and the proportion of cases which are settled with a periodical payment increases. It is assumed that there are no additional costs incurred in settling a claim, and that the outcome of a claim is unaltered by these changes.</p>	

## BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs:	Benefits:	Net:	No	NA

# Evidence Base

## 1. Introduction

- 1.1 The Lord Chancellor and his counterparts in Scotland and Northern Ireland can set the discount rate under section 1 of the Damages Act 1996. The rate is applied to lump sum payments of damages in respect of future pecuniary loss caused by personal injuries. The consultation paper that this Impact Assessment (IA) accompanies examines whether the parameters of the Lord Chancellor's and his counterparts' power, which are set by reference to section 1 and the 1998 decision of the House of Lords in *Wells v Wells*, should be reviewed. The purpose of this IA is to consider the costs and benefits associated with adopting different parameters to set the discount rate, including assumptions around what investment behaviour might be reasonable for claimants with lump sum awards. This IA also considers the costs and benefits of moving to a system of awards of damages for future pecuniary loss in which the role of lump sum payments is reduced and the role of periodical payments increased.
- 1.2 This IA does not assess the exact effect of a change in the parameters of the Lord Chancellor's and his counterparts' power or application of a methodology that might be chosen to underpin it, i.e. the IA does not seek to quantify the precise costs and benefits associated with changing the discount rate to a specific new rate of X.Y%. If a new discount rate is applied on a new basis then the IA will be updated accordingly.

### Basis of consultation

- 1.3 At present, in setting the rate the Lord Chancellor and his counterparts are guided by the principles laid down by the House of Lords in the 1998 case of *Wells v Wells*. The Ministry of Justice and its counterparts in Scotland and Northern Ireland issued a consultation paper on how the discount rate should be set under the present law on 1 August 2012 (referred to as the "first discount rate consultation" or "August 2012 consultation" in this IA). Matters within the scope of that consultation are outside the scope of the consultation to which this IA relates.
- 1.4 The consultation to which this IA relates is primarily addressing the following issues:
  - Whether the present parameters of the Lord Chancellor's and his counterparts' power to set the discount rate applicable to lump sum payments of damages for future losses and expenses in personal injury cases in England and Wales, Scotland and Northern Ireland should be changed; and, if so, how? This mainly pertains to consideration of the way claimants may reasonably be expected to invest their lump sum payments.
  - For England and Wales and Northern Ireland primarily and Scotland insofar that periodical payments are available with the consent of parties, whether the use of periodical payments instead of lump sum awards in personal injury cases should be encouraged; and, if so, how?

### Background

#### *What is the discount rate?*

- 1.5 When person A is injured by person B, person A may have a legal right to civil compensation from person B.<sup>1</sup> This compensation may be agreed between the parties, or ordered by the court, in the form of an award of damages. The principle underlying the calculation of the award is that the claimant should be compensated in full for the loss caused by the injury. The award may take the form of a lump sum or periodical payments or a combination of both. The discount rate is used in cases where a lump sum award covers future losses or expenses, including costs of care and loss of earnings. In cases of serious injury with long term consequences these awards can be very large in total. For example, awards of several million pounds have been made in relation to children's injuries.
- 1.6 In calculating the lump sum to be awarded, account is taken of the fact that it is received in the form of an immediate payment which can be invested, instead of being paid by instalments over time. This conversion of a stream of future payments into a lump sum is made by applying a

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<sup>1</sup> This excludes compensation paid by the State in criminal cases.

discount rate. The rate determines the amount by which the total value of all future payments is to be reduced to take into account the future return on investment. For example if a person is due to be paid £10,000 in 10 years' time then paying them £10,000 now would result in over-compensation, as they could invest that sum now and benefit from 10 years' worth of investment returns. The purpose of the discount rate is to ensure as far as possible that the injured person receives no more and no less than full compensation.

- 1.7 The effect of the discount rate on the size of the damages awarded depends on which rate is applied. In summary a higher discount rate equates to a lower lump sum payment (this relationship is demonstrated in chart 1 on page 11 of this document).
- 1.8 The current personal injury discount rate is 2.5% (in real terms<sup>2</sup>) and was set for England and Wales and Northern Ireland in 2001 by the Lord Chancellor based on potential returns available from Index Linked Government Securities (ILGS) (further information on the methodology is provided from paragraph 1.19). For Scotland, the rate was last set by the Scottish Ministers in 2002. The personal injury discount rate differs from other discount rates, such as the social time preference discount rate outlined in HM Treasury's Green Book, in some important regards.
- 1.9 The personal injury discount rate only takes into account the returns available from market investments and it therefore reflects the market's view of how investors should be compensated for deferring consumption and bearing risks associated with their investments as measured at a certain point in time. In contrast, the social time preference discount rate reflects the value society places on consumption in the present rather than in the future and is based on comparisons of utility across different points in time. Although these factors will be related the personal injury discount rate is narrower in its considerations than the social time preference discount rate.

#### *How many cases are affected by the discount rate?*

- 1.10 In 2011/12 1,040,000 personal injury claims were recorded by the Compensation Recovery Unit.<sup>3</sup> These included claims for compensation for injury or disease from clinical negligence, motor, employer, and other types of cases. However, not all of these claims would have involved using the discount rate as they include compensation cases covering both one-off damages awards as well as awards that compensate a claimant for a long-term injury. For example, around 540,000 of the claims recorded by the CRU related to whiplash injuries. The large majority of such claims are believed to be valued at less than £5,000 and therefore unlikely to include any payment for future losses or, if they do, for those payments to be much affected by variations in the discount rate. There is no central record of how many claims involve use of the discount rate although early indications from a MoJ research project suggest that it is likely to be a relatively small proportion of all claims.

#### *How much are the cases worth?*

- 1.11 The financial scale of the issue is difficult to assess. The total compensation paid in relation to all cases using the discount rate is unknown as this data is not collected systematically as explained at paragraph 2.5. It is known that individual cases may run into several millions of pounds as they may cover care costs and loss of earnings over a long period.
- 1.12 As an example for one large defendant, the National Health Service Litigation Authority (NHS LA), which is responsible for handling negligence claims made against NHS bodies in England, recorded that in 2011/12 almost £1.3 billion was paid out in relation to clinical negligence claims.<sup>4</sup> The NHS LA also recorded that over 21,000 claims were "live" as at 31<sup>st</sup> March 2011.

#### *What is the effect of a change in the discount rate?*

- 1.13 As mentioned previously, the discount rate is used to translate a stream of future payments into a lump sum taking into account the income which may be generated by investing the lump sum payment. However, we do not know how many cases involve compensation to cover future expenses and losses, nor do we know the quantum of future payments, their duration in time or

<sup>2</sup> The discount rate is expressed in real terms. In effect, it therefore reflects investment returns which might be accrued over and above the rate of inflation.

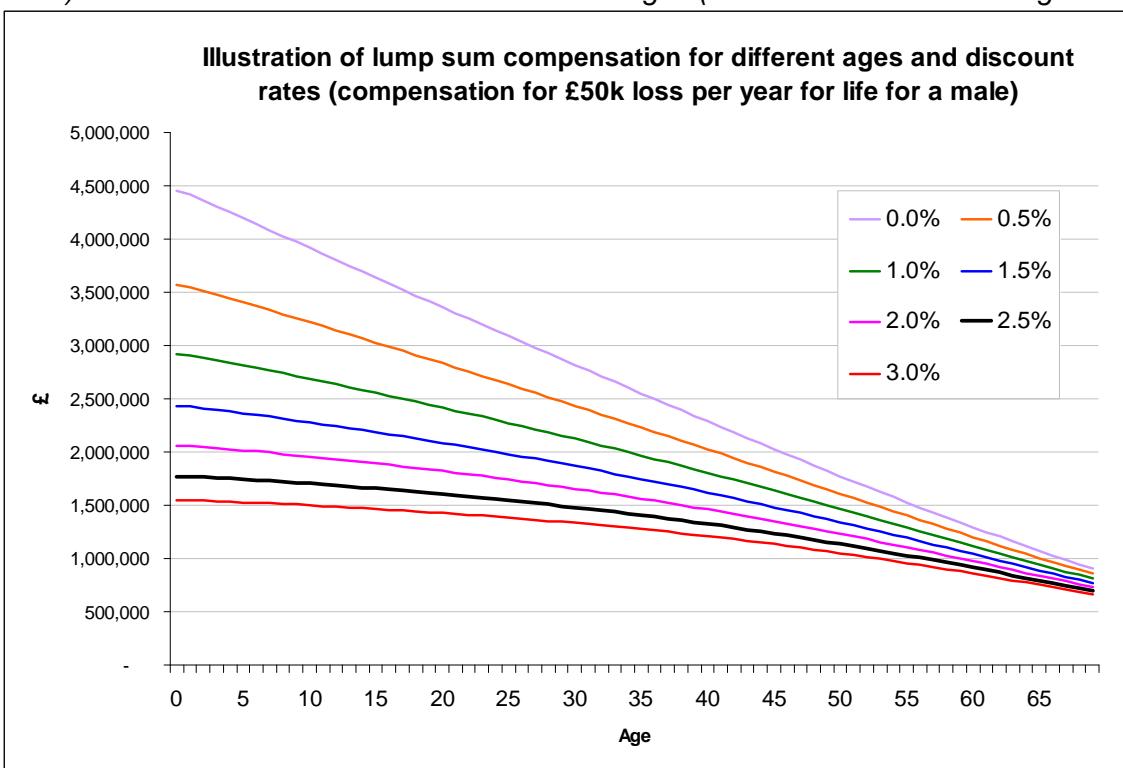
<sup>3</sup> CRU is part of the Department for Work and Pensions. It works with insurance companies, solicitors and DWP customers, to recover amounts of social security benefits paid as a result of an accident, injury or disease, where a compensation payment has been made. It also works to recover costs incurred by NHS hospitals and Ambulance Trusts for treatment from injuries from road traffic accidents and personal injury claims.

<sup>4</sup> <http://www.nhsla.com/NR/rdonlyres/465D7ABD-239F-4273-A01E-C0CED557453D/0/NHSLAFactsheet2financial201112.doc>

their time profile. In some cases an equivalent sum may not be paid every year, for example if the compensation tapers over time or if a steady stream also involves the addition of larger payments at specific points in time. Therefore, it would not be possible to estimate accurately the impact of a change in the discount rate in terms of what the aggregate change in overall total payments might be.

- 1.14 MoJ has commissioned research to help fill this evidence gap and support future IAs. In the meantime we can however provide a purely illustrative indication of the effect of a change. The relationship between the discount rate and the lump sum payment depends on both investment period (i.e. how long the lump sum is intended to compensate the individual for) and the intended profile of compensation payments (i.e. is compensation intended to be at the same level in each year or intended to increase or decrease over time?)
- 1.15 Chart 1 illustrates the relationship between lump sum payments, the age of injury and different discount rates based on the Ogden tables.<sup>5</sup> This purely illustrative chart assumes that compensation of £50k per year is awarded (in real terms) for a male claimant and the chart shows that lump sum payments are greater the younger the claimant is (and therefore the longer period the award has to cover) and the lower the discount rate is. For example, a claimant aged 10 would be awarded a lump sum of £1.7m if the discount rate was 2.5% compared to £3.2m if the discount rate were 0.5%. For a claimant aged 60 the lump sums would be £0.9m under a discount rate of 2.5% and £1.2m under a discount rate of 0.5%.

*Chart 1: Illustration of lump sum compensation payments for life time compensation of £50,000 per year (in real terms) for a male for different discount rates and ages (based on table 1 of the Ogden tables)*



- 1.16 Changes in the discount rate may therefore have significant effects but will affect different cases in different ways. As chart 1 illustrates, the greatest impact is likely to be in cases of people severely injured when young, but with a long remaining life expectancy. Many of those cases where the impact of a change is greatest may be covered by the NHSLA and may not affect costs faced by insurers and insurance premiums. However in other cases the defendant is likely to be insured and the cost of the award will be met by insurance. Decreases in the discount rate will increase awards in a number of those cases. The Association of British Insurers (ABI) gave evidence to the

<sup>5</sup> These are the tables used by parties to litigation to take into account actuarial factors in computing the quantum of damages. The latest (seventh) edition was published on 10 October 2011. The tables are prepared by the Government Actuary's Department. The tables provide factors known as multipliers which are used to assess the present capital values of future annual losses or expenses. The multipliers are based on projected future mortality rates from the 2004-based national population projections for the United Kingdom. For further information please see [http://www.gad.gov.uk/services/Other%20Services/Compensation\\_for\\_injury\\_and\\_death.html](http://www.gad.gov.uk/services/Other%20Services/Compensation_for_injury_and_death.html)

Transport Select Committee in December 2010 that its members believed reducing the discount rate from the current level of 2.5% (real) would lead to significant and immediate increases in settlements, which would have both a retrospective effect on claims filed but not yet settled and an ongoing effect on future claims. ABI warned in its evidence that these substantial and immediate increased costs on insurers of hundreds of millions of pounds were likely to be passed onto consumers through higher premiums in the absence of other changes which might lead to reduced premiums.

*How do periodical payments relate to a change in the discount rate?*

- 1.17 A periodical payment may be awarded as an alternative to a lump sum for future losses. Periodical payments specify an amount to be paid annually to claimants and may be indexed to various cost of living indices. As such, compensation paid in the form of periodical payments does not require any investment decisions by claimants and is not affected by the discount rate.
- 1.18 Periodical payments may be awarded to cover part of a total compensation award with the remainder being paid as a lump sum. The greater the proportion of an award is to be paid by way of periodical payment rather than a lump sum, the less the effect of a change in the discount rate. A statement in the NHSLA annual report for 2012 illustrates this: "Many claimants, especially in maternity incidents, are best served by receiving their damages payments over the period of their life, usually in annual amounts to pay for their continuing needs. We encourage these Periodical Payment Orders for most high value, personal injury claims which are likely to extend over a long period, because they represent the fairest method of payment both for the recipient and for the NHS. The financial provision necessary to cover these large liabilities has been identified by the NHSLA and had increased by more than 26% at the year-end to £3,040m across 1,116 Orders (up by 20%)."

*How is the discount rate set?*

- 1.19 Before the powers conferred by section 1 of the Damages Act 1996 were utilised in 2001 in England, Wales and Northern Ireland and 2002 in Scotland, the discount rate was set by the court. In the leading House of Lords case, *Wells v Wells*,<sup>6</sup> Lord Hope of Craighead summed up the purpose of the discount rate as follows: "The measure of the discount is the rate of return which can reasonably be expected on that sum of damages award, if invested in such a way as to enable the plaintiff to meet the whole amount of the loss during the entire period which has been assumed for it by the expenditure of income with capital". He added that: "The assumptions to be made at the stage of selecting the discount rate are simply these. First, it is to be assumed that the lump sum will be invested in such a way as to enable the plaintiff to meet the whole amount of the losses or costs as they arise during the entire period while protecting the award against inflation, which can thus be left out of account. Secondly, it is to be assumed that the investment will produce a return which represents the market's view of the reward to be given for foregoing the use of the money in the meantime. This is the rate of interest to be expected where the investment is without risk, there being no question about the availability of the money when the investor requires repayment of the capital and there being no question of loss due to inflation."<sup>7</sup>
- 1.20 Applying these principles, the House of Lords decided in the 1998 *Wells v Wells* case that the most accurate way of calculating the present value of the loss that claimants would actually suffer in real terms was to assume an investment of the award of damages in ILGS.<sup>8</sup> The discount rate therefore reflects the rate of return to be expected from the investment that an investor with a low appetite for risk would make. However, the House of Lords also concluded that this did not mean that the court had to reach any conclusion about what an individual claimant would actually do with the money when they received it.
- 1.21 Under section 1 the Lord Chancellor and his counterparts are able to set one or more discount rates in accordance with the guidelines laid down in *Wells v Wells*. The court is required to take the prescribed rate into account but can adopt a different rate where appropriate in particular cases. The current rate of 2.5% was set by the then Lord Chancellor in 2001 and the Scottish Ministers in 2002, broadly by reference to the average gross redemption yield of ILGS issued by the UK Government over the preceding three years.

<sup>6</sup> [1999] AC 345.

<sup>7</sup> Ibid 390G–391C.

<sup>8</sup> Gilt is the name given to bonds issued by the UK Government.

- 1.22 On 1 August 2012 the Ministry of Justice and its counterparts in Scotland and Northern Ireland issued a consultation paper on how the discount rate should be set. This consultation was driven by a concern that the current discount rate of 2.5% (real) may be too high and awards of damages are consequentially too low because the rates of return on ILGS have significantly declined since the rate was last set.
- 1.23 Despite the fall in rates of return on ILGS, we are not aware of any evidence that the awards obtained under the present rate are leaving claimants short of money. This could be for many reasons but a contributing factor may be that the discount rate is only one factor in the creation of a settlement of a personal injury case. The August 2012 consultation is aiming to identify a methodology by which the rate should be set on the basis of the current law.
- 1.24 The consultation to which this IA is related is independent of and separate from the consultation of August 2012.

### **Problem under consideration**

- 1.25 The problems under consideration in the consultation paper to which this IA relates are; whether the present parameters of the Lord Chancellor's and his counterparts' power to set the discount rate are still appropriate and / or whether steps should be taken to increase the use of periodical payments.
- 1.26 This review is prompted by concerns that if the discount rate has to be set by reference to the returns on low risk investments (as is the case under the present law) then claimants will in fact be over-compensated. This is because it may be reasonable for claimants to invest in higher yielding investments (and in practice they may actually be doing so). The effect of this over-compensation will be additional and unfair burdens on defendants and their insurers. The cost of this over-compensation will fall to some extent on the taxpayer and, through increased insurance costs, on the consumer.
- 1.27 If this criticism is correct then different assumptions from those adopted by the House of Lords in *Wells v Wells* to define how the discount rate should be set will be needed to deliver the principle of full compensation (the 100% rule) as nearly as is possible. The investments chosen as the measure of the rate of return as a result would be expected to produce a higher rate of return (and discount rate) than the current law permits and a methodology would have to be settled to translate the rate of return from such investments into a discount rate.
- 1.28 As the take up of periodical payments can reduce the effect of a change in the discount rate and deliver benefits to the claimant the consultation also considers whether steps could and should be taken to increase the take up of periodical payments.

### *Evidence for policy problem*

- 1.29 A comprehensive evidence base on the investment behaviour of personal injury claimants, which may influence judgements on what it is reasonable for them to invest in, is not currently available. Claimants' investment decisions and the reasons underpinning them are not routinely recorded as they are private decisions which are not subject to government monitoring and are not consistently recorded by other stakeholders such as solicitors, insurers or financial advisers.
- 1.30 Some anecdotal evidence is available which suggests that claimants may invest in a broad range of relatively safe assets which are not restricted to ILGS. MoJ has undertaken some preliminary investigations into investment advice and practices with a small number of financial advisers who provide advice to personal injury claimants about what assets they might invest in. These advisers have suggested that personal injury claimants might be advised to invest in relatively cautious mixed portfolios with an emphasis on income generation. Such portfolios might predominantly be based on safe equities and fixed income investments such as government gilts and corporate bonds. They may also include some alternative investments such as gold, property, hedge funds and cash although the proportions of each investment class will vary from case to case. These indicative portfolios included both sterling and foreign currency denominated assets.
- 1.31 There are some qualifications which need to be borne in mind when considering these portfolios. Firstly, it is not clear whether claimants' are advised to invest in such portfolios because of necessity (i.e. because the discount rate is currently high relative to ILGS yields) or because of their preferences (i.e. they would anyway choose an investment which is more risky than just ILGS). It has been highlighted that personal injury claimants tend to be relatively cautious and that the current discount rate and economic conditions mean that claimants may have to take on

greater investment risks than they would like to in order to generate returns that are sufficient for their requirements. Moreover, it is not clear whether the portfolio illustrated above would be typical for the whole of a claimant's lump sum payment. Claimants may want to keep some of their funds as cash to maintain flexibility in expenditures whilst investing the remainder in a mixed portfolio. There is also likely to be considerable variability in the portfolios held by different claimants.

- 1.32 Historically, a mixed portfolio might have outperformed investing in ILGS alone although this very much depends on which period is considered. For example, over the last decade gilt returns have been strong relative to equities although over longer period (30 years or longer) equities have tended to yield higher real returns.
- 1.33 In general a mixed portfolio would have greater "market risks" (these comprise risks arising out of volatility and uncertainty in the price or income of investment – e.g. a bond issuer defaults) than ILGS and would be reflected in a higher average rate of return over long periods of time. However, ILGS may be more prone to other types of risk such as "mismatch" risk<sup>9</sup> which may mean that a mixed portfolio is not necessarily significantly more risky overall.
- 1.34 It should also be recognised that past yields are not necessarily a good indication of future returns and this is especially true in the short term where prevailing economic conditions may be particularly important. For example, although gilts have delivered relatively high returns over the past 10 years these might not be expected to be sustained into the future because gilt prices are now relatively high.
- 1.35 Further evidence on claimants' investment decisions will be sought as part of the consultation. MoJ has also commissioned a research study to look at the potential impact of changing the discount rate.

### Economic rationale

- 1.36 The conventional economic approach to government intervention is based on efficiency or equity arguments. Governments may consider intervening if there are strong enough failures in the way markets operate, e.g. monopolies overcharging debtors, or if there are strong enough failures in existing government interventions, e.g. outdated regulations generating inefficiencies. In all cases the proposed intervention should avoid generating a further set of disproportionate costs and distortions. Governments may also intervene for reasons of equity (fairness) and for redistributive reasons (e.g. reallocating resources from one group in society to another).
- 1.37 In this case intervention is justified on equity (fairness) grounds. The current discount rate methodology and the way it is applied may produce over-compensation. This would be unfair to defendants and impose unnecessary costs on society generally. The reforms considered in the consultation paper would be justified if they resulted in increased equity and increased accuracy in the discount rate.

### Policy objectives and proposals

- 1.38 In setting the rate the Lord Chancellor and his counterparts are acting in a quasi-judicial capacity to fulfil the statutory duty placed on them by the 1996 Act to specify a discount rate. While there is no single 'right' rate, the overall aim is to make the rate as far as possible an accurate assessment of the benefit to the claimant of the accelerated receipt of compensation for future losses and expenses.
- 1.39 Theoretically, the rate might be expected to change as often as the returns on the investments used to calculate it. This would, however, create uncertainty and make it more difficult to settle disputes. Whilst change at some point may become necessary, some degree of stability is desirable from a practical point of view. Similarly, the purest solution might be to leave it to the parties to calculate the rate on a case by case basis. This could be very expensive and also make disputes much harder to settle. A general discount rate is therefore required, which is relatively

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<sup>9</sup> 'Mismatch risks' are related to what the specific investor wants the money for. They are the risk that the result of making the investments does not match the individual investor's objective in making the investments. In the case of ILGS potential mismatch risk include the risk that gilts that mature when investors need them may not be available and that an investor's personal rate of inflation is greater than index applied to the gilt. These risks may be mitigated in a mixed portfolio through the mix of assets chosen.

simple to calculate and apply. A single rate currently applies, and this IA assumes that a single rate will continue to apply in future.

- 1.40 As explained, the main issue to be examined in the consultation paper to which this IA relates is whether the parameters on the Lord Chancellor's and his counterparts' power to set the rate – essentially the guidelines laid down by the House of Lords in *Wells v Wells* – are actually delivering full compensation or could in fact inherently over-compensate claimants.
- 1.41 For these purposes the Lord Chancellor and his counterparts will need to identify suitable investments for personal injury claimants that are less risk-averse than is assumed at present and ascertain what the return on those investments is likely to be. The primary issue therefore to identify a reasonable risk profile that may be assumed for claimants and to identify what investments best match this risk profile.
- 1.42 In choosing an appropriate set of investments we generally expect to be guided by the following principles:
  - a. **Accuracy:** the rate should provide as accurate as possible a reflection of the return to investment claimants could reasonably make so as to ensure as far as possible that they are not under- or over-compensated.
  - b. **Transparency and simplicity:** calculation of the rate should be easy to understand and easy to perform.
  - c. **Stability:** for simplicity and certainty frequent changes in the rate should if possible be avoided.
- 1.43 To this end, this IA identifies and examines the following broad options:
  - a. **Option 1:** Change the legal framework for setting the discount rate to reflect a mixed portfolio of financial assets.

Option 1 may have two outcomes relative to the current discount rate of 2.5% in real terms (the base case), each of which are considered below:

    - Option 1A: The discount rate is greater than 2.5% (in real terms)
    - Option 1B: The discount rate is lower than 2.5% (in real terms)
  - b. **Option 2:** Encourage greater use of periodic payment orders in place of lump sum settlements. For Scotland, consideration of this option is limited as periodical payment orders can only be made with consent of the parties involved.
- 1.44 Options 1 and 2 are not mutually exclusive and may be complementary. For example, awards can be comprised of both lump sum and periodical payment elements and, therefore, greater use of periodical payments does not preclude changes to the basis for setting the discount rate. Option 2 would address the identified problem by removing the requirement for investment decisions by claimants for some or all of their compensation and it would therefore avoid or reduce under or over-compensation which may occur as a result of investment performance.
- 1.45 Depending on the outcome of both discount rate consultations, a combination of both options could be considered for implementation. The Government does not have a preference exclusively for Option 1 or 2.
- 1.46 A key factor in choosing a portfolio of assets under Option 1 is the degree of market risk that is judged to be reasonable for claimant investors to take. The discount rate set should accurately reflect the rate of return expected from investments that a claimant investor could reasonably be assumed to make. The primary issue therefore is simply what portfolio of assets best matches a reasonable risk profile for claimants. Views on this are being sought as part of this consultation and evidence might include the behaviour of actual claimants and long term returns from different types of investments. At this stage, this IA considers the broad type of investments that might be made and does not specify a particular portfolio of assets in detail.
- 1.47 This IA also does not consider in detail changes in the methodology for setting the discount rate which are subject to a separate UK-wide consultation (the “August 2012 consultation”). For Option 1, therefore, this IA does not consider a specific methodology for setting the discount rate based on

the chosen portfolio of assets although it is assumed that the methodology chosen would accurately reflect the returns available to claimants from the relevant portfolio.

- 1.48 Irrespective of the portfolio of assets which may ultimately be chosen, it is only the rate that may change. There is no intention to change either of the following aspects of the current law.
- There is no legal obligation on claimants to invest their funds in accordance with the investment behaviours which underpin the discount rate. Instead, claimants may do what they like with the money received. Nonetheless, we anticipate that where a claimant chooses to invest, the investments chosen may well be affected by the amount of money received relative to his or her requirements and that therefore different discount rates may lead to different investment choices.
  - It is not compulsory for the court to use the prescribed rate. The court may substitute a different discount rate if it is persuaded by one of the parties that another rate is more appropriate. Nonetheless, we understand that in the past the prescribed rate has rarely been challenged.

- 1.49 The current consultation also considers how the discount rate may be kept up to date and for the purposes of this IA it is assumed that the mechanism chosen to update the discount rate will be sufficient to ensure that the discount rate remains appropriately accurate. As such, the mechanism itself is not assumed to result in direct impacts which need to be detailed within this IA.

### Affected stakeholder groups, organisations and sectors

- 1.50 The following individuals/sectors are likely to be affected by the proposal:

- Claimants in personal injury cases.
- Legal services providers and financial advisers.
- Defendants in personal injury cases, including public sector bodies, such as NHS, other businesses and individuals (including those paying insurance premiums), and insurers.
- HM Courts & Tribunals Service and the Ministry of Justice.
- Scottish Court Service and the Scottish Government.
- Northern Ireland Courts and Tribunals Service and the Department of Justice.

## 2. Costs and benefits

- 2.1 This IA identifies impacts on individuals, groups, bodies and businesses in the UK, with the aim of understanding what the overall impact to society might be from implementing these options. The costs and benefits of Option 1 and 2 are compared to the do nothing base case (Option 0). IAs place a strong emphasis on valuing the costs and benefits in monetary terms (including estimating the value of goods and services that are not traded). However there are important aspects that cannot sensibly be monetised. These might include how the proposal impacts differently on particular groups of society or changes in equity (fairness), either positive or negative.
- 2.2 As explained above this IA does not consider the precise impacts of moving from 2.5% in real terms (the current rate) to a new specific rate in future such as X.Y%. This will be considered in a future updated version of the IA once the outcome of this consultation and the first consultation has been confirmed.
- 2.3 A comprehensive evidence base is not currently available to MoJ, the Scottish Government or the Department of Justice in relation to the quantum, components and profile of compensation payments and this information would be needed to produce a full quantitative assessment of the impact of changing the discount rate. It appears that this data is not recorded systematically by claimant or defendant organisations and this may be a result of the process for settling claims which tends to be heavily influenced by negotiations. Early findings from the research project mentioned in this IA suggest that the settlement process is made up of the following steps which are not conducive to recording comprehensive data on the components of lump sum settlements:
- A claim is lodged – this may be based on a detailed claims schedule which outlines the different losses being claimed for in the past and for each year in the future (i.e. loss of earnings, care, assistive technology etc) and uses the discount rate and Ogden tables for future losses to produce a total lump sum claim.

- b. A counterclaim is lodged by the defendant – the detail of this counter claim varies and it may simply be a commentary on the initial claims schedule.
  - c. Negotiations – these can be protracted and complex and there is inconsistency across different claims. Changes to the original claims schedule do not appear to be recorded in detail and negotiations may be around the lump sum total rather than individual elements.
  - d. Settlement – once a lump sum is agreed between claimants and defendants, or ordered by the court, it is paid to the claimant.
- 2.4 This process makes estimating the impact of a change in the discount rate difficult because negotiations mean that it is difficult to ascertain how much of a lump sum award pertains to future losses.
- 2.5 However, MoJ is seeking to gain a better understanding of the impact of changing the discount rate through both discount rate consultations and the research project. The research project seeks to gather the quantitative information that is available on the volume, value and characteristics (including information on the time profile of compensation, claimants, defendants and case types) of cases from public sector organisations (such as the NHSLA and CRU) and defendant and claimant stakeholders. The research and consultation also seek to gather information on claimants' investment behaviour, the settlement process and the impact of changing the discount rate on different stakeholders.
- 2.6 The constraints imposed by the settlement process highlighted above mean that a full quantitative assessment of the impact of changing the discount rate may remain difficult after data has been collected, although indicative estimates of the impacts may be possible by applying reasonable assumptions to datasets. These assumptions would be informed by the qualitative field work undertaken by researchers and by consultation responses.

### **Option 0: Base case (do nothing)**

- 2.7 Option 0 is the base case and reflects the existing discount rate of 2.5% (in real terms). As mentioned previously, the August 2012 discount rate consultation may result in a change in the discount rate, although the magnitude of this change depends on the methodology chosen.
- 2.8 At this stage, it is not known what discount rate might prevail as a result of the first consultation and, therefore, for the purposes of this IA the current discount rate of 2.5% (real) is being used as the baseline against which Options 1 and 2 are assessed.
- 2.9 As this option's costs and benefits are compared against themselves they are necessarily zero, as is its net present value.

### **Option 1: Change the parameters used to set the discount rate to reflect a mixed portfolio of financial assets**

#### **Description**

- 2.10 Under this option the legal basis for setting the discount rate would be changed to reflect a mixed portfolio of financial assets so that it better reflects a reasonable assumption about how personal injury claimants could invest lump sum payments.
- 2.11 There are a range of options for what could be included in the investment portfolio including different asset classes such as; fixed income investments (including government gilts and corporate bonds), equities, cash and alternative investments such as gold, property and hedge funds. There are also a range of investments which might be chosen within each of these asset classes.
- 2.12 As discussed above, initial discussions with fund managers suggest that personal injury claimants might be advised to invest in relatively cautious mixed portfolios with an emphasis on income generation. Such portfolios might predominantly be based on safe equities and fixed income investments such as government gilts and corporate bonds. They may also include some alternative investments such as gold, property, hedge funds and cash although the proportions of each investment class will vary from case to case. These indicative portfolios included both sterling and foreign currency denominated assets.

- 2.13 At this stage no firm views are held regarding the proportions of different types of assets that might be included in a mixed portfolio and it is anticipated that the final choice of assets would be informed by evidence on actual claimants' behaviour, advice from financial advisers and other information such as long run returns on financial assets. Both discount rate consultations and independent research commissioned by the Ministry of Justice seek to gather further evidence on the investment preferences of personal injury claimants.
- 2.14 There are also a number of methodological issues that need to be considered in calculating a discount rate, including the period over which returns are assessed and allowances for inflation, tax and investment expenses. For the purposes of this IA, however, no set methodology is identified although it is recognised that different methodologies would result in higher or lower discount rates. It is assumed that the methodology chosen would accurately reflect the returns available from the chosen investments.
- 2.15 As outlined earlier, for the purposes of this IA, the costs and benefits of all options are compared to the current rate of 2.5% (real) and, as the components of a mixed portfolio remain uncertain, Option 1 could result in a higher or lower rate than this. This IA, therefore, considers both possibilities:
- Option 1A assesses the impacts if the new legal basis results in a rate higher than 2.5% in real terms.
  - Option 1B assesses the impacts if the new legal basis results in a rate lower than 2.5% in real terms.
- 2.16 For the purposes of assessing costs and benefits in this IA it is also necessary to make assumptions about the preferences and investment behaviour of different claimants, as this will determine the costs and benefits that they face under Options 1A and 1B. As stated previously, little information is available on claimants' investment preferences, but it would be expected that, in reality, claimants vary in their appetite for market risks. In this IA it is assumed that claimants may be split into two broad groups with reference to the discount rate:
- Claimants whose risk appetite is lower than that implied by the discount rate. This group of claimants would prefer to invest in assets that have less market risk and lower average returns than those used to set the discount rate. Following changes in the discount rate, these claimants may behave in the following ways:
    - They may invest in assets that are lower risk and have a lower average returns than those which the discount rate is based on, as per their risk appetite, or;
    - They may invest in assets that are more risky and have higher average returns than their risk appetite implies.
  - Claimants whose risk appetite is equal to or higher than that implied by the discount rate. This group of claimants would prefer to invest in the assets which are used to set the discount rate or riskier assets with higher average returns. It is assumed that this group of claimants would invest in assets which align with their risk appetite following changes in the discount rate.

2.17 The costs and benefits to each of these types of claimants are outlined below.

### **Option 1A: Description**

- 2.18 Option 1A assesses the impacts of a change in the legal basis if the new legal basis results in a rate higher than 2.5% in real terms. A higher discount rate will lead to lower lump sum compensation payments as future losses would be more heavily discounted. This primarily represents a transfer from claimants to defendants including insurers (and may thereby affect wider society that pays insurance premiums).

### **Option 1A: Costs**

- 2.19 There may be some one-off familiarisation costs for all affected parties. These costs are expected to be negligible.

#### **Costs to claimants**

- 2.20 A higher discount rate would result in reduced lump sum compensation to claimants relative to the base case. This would be a cost to claimants and a benefit to defendants.

- 2.21 A higher discount rate may also lead to costs to some claimants if they invest in assets with more market risks than they otherwise would have done in order to ensure that their lump sum award meets their requirements.
- 2.22 As outlined at paragraph 2.16, some claimants who have a risk appetite lower than that implied by the new discount rate may choose to invest in riskier assets than their appetite implies, as a result of a change in the discount rate. Such claimants would face higher costs associated greater volatility if investment risks materialise. This may include the market risks outlined in the paragraph below.
- 2.23 The capital investment could be volatile due to the inclusion of riskier assets such as equities. There could also be a higher level of credit risk on the capital value associated with companies defaulting and, if some proportion of the investment is held in non-Sterling investments, there could be a risk arising from exchange rate fluctuations. Although equities offer some protection against inflation, they are not index-linked, unlike ILGS. Therefore capital values could fluctuate, leading to a risk that an investor forced to sell to meet costs as they arise might get a low price for the asset and deplete the award of damages more quickly than planned.
- 2.24 These claimants may also face additional costs associated with managing their investments although these may be passed on to defendants as part of the total compensation award.
- 2.25 Alternatively, if claimants with lower risk appetites are unwilling to invest in the types of assets used to set the discount rate they may invest in less risky assets with lower average rates of return. In this case they would not fully achieve the stream of income assumed in their settlement which would represent a cost to them.
- 2.26 Claimants who have a risk appetite equal to or greater than that implied by the discount rate are assumed to continue to invest in assets which are consistent with their risk appetite and are assumed to face no additional costs from investment risk or management.

#### **Costs to defendants**

- 2.27 As explained above, any change in the costs to claimants of managing lump sums might ultimately be passed to defendants as part of negotiating the final settlement.

#### **Costs to MoJ (including HMCTS) and their counterparts in Scotland and Northern Ireland**

- 2.28 The costs to MoJ of setting and reviewing the discount rate may be higher than the base case as a specific set of investments would need to be identified and selected in order to apply a new legal basis. These costs would be higher if the portfolio was diverse and data was not readily available in relation to all of the investments included.

### **Option 1A: Benefits**

#### **Benefits for defendants**

- 2.29 A higher discount rate is expected to result in reduced lump sum compensation payouts by defendants relative to the base case. Defendants will include insurers, government bodies such as the NHS and uninsured businesses and individuals. In the case of insurers this could lead to benefits which might be passed on to consumers in the form of lower insurance premiums relative to the base case.

#### **Benefits to society and wider economy**

- 2.30 Society may benefit from greater equity (fairness) if the current legal basis tends to over-compensate personal injury claimants.
- 2.31 Individuals and businesses in wider society may also benefit from lower insurance premiums if insurers face lower costs. Such businesses and individuals would also be potential defendants. This would be a second round impact of this proposal.

### **Option 1B: Description**

- 2.32 Option 1B assesses the impacts of a change in the legal basis if the new legal basis results in a rate lower than 2.5% in real terms. A lower discount rate will lead to higher lump sum compensation payments as future losses would be less heavily discounted. This primarily represents a transfer from defendants to claimants.

## **Option 1B: Costs**

2.33 There may be some one-off familiarisation costs for all affected parties. These costs are expected to be negligible.

### **Costs to defendants**

2.34 A lower discount rate would result in increased lump sum compensation to claimants relative to the base case. This would be a cost to defendants and a benefit to claimants. Defendants will include insurers, government bodies such as the NHS and uninsured businesses and individuals. In the case of insurers this could lead to costs which might be passed on to consumers in the form of higher insurance premiums relative to the base case.

### **Costs to MoJ (including HMCTS) and their counterparts in Scotland and Northern Ireland**

2.35 The costs to MoJ of setting and reviewing the discount rate may be higher than the base case as a specific set of investments would need to be identified and selected in order to apply a new legal basis. These costs would be higher if the portfolio was diverse and data was not readily available in relation to all of the investments included.

### **Costs to society and wider economy**

2.36 There may be a cost to individuals and businesses in wider society from higher insurance premiums if insurers face higher costs. Such businesses and individuals would also be potential defendants. This would be a second round impact of this proposal.

## **Option 1B: Benefits**

### **Benefits for claimants**

2.37 A lower discount rate is expected to result in increased lump sum compensation payouts to claimants. This would be a benefit to claimants and a cost to defendants.

2.38 Compared to the base case, there may be additional benefits to claimants with lower risk appetites than implied by the discount rate if they would otherwise have taken on a greater level of risk than desired (this represents the opposite impact as that identified in paragraphs 2.20 and 2.21). This is because the reduction in the discount rate would bring it closer in line with their risk appetite and they would, therefore, be able generate the same stream of income from their investments at a lower level of risk than they would have done had the discount rate remained at 2.5% (real).

### **Benefits to society and wider economy**

2.39 Society may benefit from greater equity (fairness) if the new legal basis more accurately compensates personal injury claimants.

## **Option 1: Risks and Assumptions**

2.40 It is assumed that the discount rate under Option 1 would reflect a reasonable rate of return which may be achieved by a typical personal injury claimant investing their lump sum compensation payment. Under Option 1A it is assumed that the discount rate would be higher than the current 2.5% real rate outlined in Option 0 (base case) and under Option 1B it would be lower than 2.5%. This consultation and research commissioned by the Ministry of Justice seek to gather further evidence on the investment preferences of personal injury claimants and evidence from other sources.

2.41 It is assumed that, under this Option 1, the investment preferences and decisions of personal injury claimants may vary as per the assumptions outlined in paragraph 2.15.

2.42 It is assumed that there is no change in the volume of periodical payment orders. It is possible that a change in the discount rate relative to the base case would change claimants' and defendants' appetite for settling claims in the form of a periodical payment order. If the number of cases settled via periodical payment orders changed the impacts would be similar to those described in Option 2 below.

- 2.43 It is assumed that there is no change in the volume of personal injury claims. The claims most affected by the discount rate are generally large claims and personal injury claimants are expected to bring these irrespective of the level of the discount rate.
- 2.44 It is assumed that there is no change in the costs of reaching a settlement and that changing the discount rate does not affect the outcome of negotiations. There is no evidence available to suggest that settlement costs will change if the legal basis for setting the discount rate changes.
- 2.45 It is assumed that there is no impact on legal service providers aside from the familiarisation costs described above. These are not expected to be significant.
- 2.46 It is assumed that there are no significant impacts on financial advisers or financial markets (for example, levels of borrowing made available to businesses as a result of changes in investment decisions). If the costs of managing lump sum compensation payments changed as a result of Option 1 this could have some minor impacts on the volume of business for financial advisers. This would be a second round impact.

## **Option 2: Encourage greater use of periodical payment orders**

### **Description**

- 2.47 Under this option greater use of periodical payment orders would be encouraged. The mechanism through which this would be achieved is not firmly established at this stage and the consultation associated with this IA seeks evidence to help inform this.
- 2.48 Periodical payment orders mainly represent a change in cash flows for defendants and claimants. Rather than an upfront lump sum, compensation for future losses is paid out over time, usually on an annual basis. This means that the discount rate does not affect the size of the award. Effectively the responsibility for managing the investment to generate the income required at future points in time and the responsibility for bearing mortality risk<sup>10</sup> switches from the claimant to the defendant.
- 2.49 It is understood that periodical payment orders are not currently used in a large proportion of cases, although it is possible that their use may change if the discount rate changes as part of the review of the methodology (the August 2012 consultation). Where periodical payment orders are used the settlement will usually include a lump sum award to compensate claimants for past losses, and also potentially to cover some future losses. The NHS Litigation Authority appears to use periodical payment orders more frequently than some other defendants.
- 2.50 There is little comprehensive evidence available on the reasons why claimants and defendants choose periodical payment orders over lump sum payments although the following factors may be taken into consideration. This list is not exhaustive:
  - a. Certainty: periodical payments can be guaranteed over the course of a claimant's life and, therefore, uncertainty for claimants associated with investment performance and life expectancy is removed.
  - b. Inflation and tax adjustments: periodical payments may be linked to changes in health care costs which may increase faster than the general price level. Periodical payments are also tax free. These factors can mitigate the risk of a shortfall in finances.
  - c. The investment potential of a lump sum: if this is high relative to a periodical payment claimants may prefer a lump sum payment. The discount rate will influence as it helps to determine the lump sum.
  - d. Security of defendant: if the defendant is not financially secure, for example, under the Financial Services Compensation Scheme,<sup>11</sup> a periodical payment may not be appropriate as it may not be paid if the defendant became insolvent.
  - e. Flexibility: periodical payments are generally less flexible than a lump sum as claimants' profile of expenditure may be limited by the stream of periodical payments.

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<sup>10</sup> The risk that a claimant dies earlier or later than expected.

<sup>11</sup> The Financial Services Compensation Scheme is a fund of last resort set up under the Financial Services and Markets Act 2000 to compensate customers of authorised financial services firms in the event of their insolvency.

- f. Liability deductions:<sup>12</sup> if the total compensation represents less than 100% of future losses incurred due to liability reductions then it becomes more difficult to meet annual recurring needs through periodical payments.
  - g. Finality of the case: periodical payments may not represent “closure” of the case for some claimants.
- 2.51 For the purposes of this IA it is provisionally assumed that there is currently some impediment to or bias against the use of periodical payment orders and that this policy would result in greater use of these orders.
- 2.52 As stated above, periodical payments may be viewed as transferring investment and mortality risks from claimants to defendants and it is assumed that, for a given discount rate, periodical payments and lump sum payments represent the same overall award for compensation. As such, the costs and benefits of periodical payments to claimants and defendants would depend on their willingness and ability to invest lump sums and whether, on average, they would generate a return greater than the discount rate. In the assessment of costs and benefits, the following simplifying assumptions have therefore been made about the risk appetites of claimants and defendants;
- a. It is assumed that claimants may vary in their risk appetites and compared to the base case of a 2.5% (real) discount rate their risk appetite is either higher or lower.
  - b. It is assumed that, on average, defendants have a greater appetite for investment risks than implied by the discount rate and that, on average, they would be able to generate greater returns from investment. Effectively this means that defendants can bear the risks associated with investments at a lower cost than claimants are able to.
- 2.53 Although we have little evidence on the risk preferences of claimants and defendants, it may be reasonable to assume that on average defendants would be more willing and able to bear investment risks than personal injury claimants. This is because defendants include large insurers and businesses that may be able to pool investments and spread risks across a number of cases which claimants are unable to do.

## **Option 2: Costs**

- 2.54 There may be some one-off familiarisation costs for all affected parties. These costs are not expected to be significant.

### ***Costs to claimants and their relatives***

- 2.55 Periodical payments offer less flexibility to claimants than a lump sum payment. This is because it is less easy for a claimant to spend or invest their compensation in ways that they may wish, for example they would not be able to make large upfront expenditures. The lack of flexibility also means that if care needs increase earlier than anticipated or if there are other unanticipated costs claimants may not be able to adjust their expenditure to fully meet these.
- 2.56 Periodical payments may also represent a cost to claimants with risk appetites greater than that implied by the discount rate. On average, these claimants may have been able to achieve a greater overall stream of financial payments if they had received a lump sum rather than a periodical payment.
- 2.57 Under this option, there may also be a cost to some claimants and their family and friends if they die earlier than expected. Periodical payment orders will often cease upon the death of a claimant. This means that where claimants switching to periodical payment orders died earlier than expected, they would not be able to pass compensation for future losses beyond their death onto their family and friends. This would represent a cost to claimants and those that would benefit from such legacy payments. However, this cost to some claimants is assumed to be offset by a benefit to other claimants who live longer than expected.
- 2.58 Claimants may face some new administrative costs under periodical payments, for example, because they have to prove that they are still alive on an annual basis. For some claimants personal injury litigation also represents a traumatic experience which they may wish to put behind

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<sup>12</sup> Deductions to compensation awards may be made of claimants are deemed to be partly liable for their injuries. For example, by not wearing a seat belt in a road traffic accident.

them. For such claimants, a periodical payment may not represent “closure” and there may be emotional costs associated with this.

### ***Costs to defendants***

- 2.59 There may be additional administrative costs to defendants associated with periodical payments, for example defendants would need a system for recording and paying out periodical payments and verifying proof of life of the claimant.
- 2.60 Defendants may also incur investment management costs associated with ensuring that sufficient funds are available at the relevant points in the future. However, lump sum payments sometimes include an allowance for claimants’ investment management costs and so it is possible that this could benefit defendants if they are able to manage the funds at lower cost than they currently payout to claimants for these purposes.
- 2.61 Under periodical payment orders defendants would be responsible for bearing mortality risk and potentially investment risks, this represents a shift of risk from the claimant to the defendant when compared to a lump sum award. There would be net costs to defendants if the costs to them of bearing these risks was higher than the price they pay claimants to bear them (for investment risks this is taken account via the discount rate). However, it is assumed that, on average, it would be less costly for defendants to bear investment risk than it is for claimants as defendants include large insurers and businesses that may be able to pool investments and spread risks across a number of cases. Mortality risks should have a neutral impact across all defendants compared to the base case, assuming that mortality assumptions used in the calculation of lump sums reflect actual outcomes on average.
- 2.62 The consultation accompanying this IA seeks to gather further evidence on what the additional costs to defendants might be.

### ***Costs to financial advisers***

- 2.63 There may be a reduction in demand for financial advice from claimants if there is an increase in the use of periodical payments. However, this may be offset by an increase in demand from defendants. These impacts are considered to be a secondary effect of this proposal.

## **Option 2: Benefits**

### ***Benefits to claimants***

- 2.64 Periodical payments guarantee a sum of money to be paid annually to claimants for the course of their life and therefore offer greater certainty than a lump sum payment. This may have benefits by removing claimants’ exposure to mortality and investment risks.
- 2.65 Periodical payment orders will often continue until the death of a claimant in contrast to lump sums which are based on an expected period of life. This means that where claimants live longer than expected they will continue to receive annual compensation for their injury. This would therefore represent a benefit to such claimants.
- 2.66 Investment risks no longer apply to claimants who receive periodical payments. This includes risks associated with volatility in income and capital returns, default and mismatching of investments to financial requirements. This would represent a benefit to claimants that have a risk appetite lower than that implied by the discount rate as they would now receive the same level of compensation without facing investment risks. Alternatively, if these claimants would have otherwise invested in lower risk assets, with average rates of return lower than the discount rate, they would receive a greater stream of income under periodical payments.
- 2.67 Claimants would no longer be responsible for managing the investment of the lump sum and so might benefit from lower time, stress and other costs associated with the financial management of a large sum. Although, as mentioned, investment management costs might be met by defendants as part of the settlement.

### ***Benefits to defendants***

- 2.68 Greater use of periodical payment orders would mean that defendants pay out a smaller lump sum upon settlement of claims but had higher ongoing payouts from the additional periodical payments. Overall the compensation paid out is assumed to be the same (once the discount rate is taken into consideration) but compared to the base case defendants would have the use of some additional

funding in the short term. On average, it is assumed that this would be a benefit for defendants as they are able bear investment risks at a lower cost than they would pay claimants for as part of a lump sum (via the discount rate). In general, defendants such as insurers might be expected to pool funding across a number of personal injury claimants and thereby achieve a higher return than the discount rate at lower risk compared to an individual claimant.

- 2.69 As mentioned in the costs section, defendants may benefit if claimants die earlier than expected although across all cases this impact is assumed to be neutral.
- 2.70 Defendants may benefit if they are able to manage investments at a lower cost than claimants would be able to as defendants may cover claimants' investment management costs as part of the settlement. This may be expected because defendants may benefit from economies of scale as well as experience and expertise in investing.

### ***Benefits to society and wider economy***

- 2.71 Society may benefit from greater equity (fairness) if greater use of periodical payment orders provides a more accurate level of compensation for future losses.

### **Option 2: Risks and Assumptions**

- 2.72 It is assumed that lump sums and periodical payments represent the same overall award for compensation. This means that, on average, the amount paid out by defendants under either arrangement would be the same, when both are compared on a common basis by adjustments to reflect the discount rate. However, this may vary in individual cases depending on life duration as outlined in the costs and benefits section.
- 2.73 Assumptions about claimants' and defendants' relative risk appetites are outlined at paragraph 2.52. There is a risk that defendants are, on average, unable to achieve investment returns greater than the discount rate or, equivalently, bear investment risks at a lower cost than claimants. If this occurs then defendants would face a cost when periodical payments are used in place of lump sum payments.
- 2.74 It is assumed that there is no change in the costs of reaching a settlement. It is possible that the cost of reaching a settlement that includes a periodical payment order might be higher or lower than the cost of reaching a wholly lump sum settlement. The consultation accompanying this IA seeks to gather evidence on any change in settlement costs from a shift to periodical payment orders.
- 2.75 It is assumed that there is no change in the volume of personal injury claims and that the proportion of compensation awards that include a periodical payment order increases. The claims most likely to involve periodical payment orders are large claims and personal injury claimants are expected to still bring these claims even if the policy around periodical payment orders changes.
- 2.76 There are not expected to be any significant additional resource costs to MoJ (including HMCTS) and in Northern Ireland, the Department of Justice (including NICTS) from a greater use of periodical payment orders.

### **One-In One-Out (OIOO) Assessment**

#### ***Option 1: Change discount rate to reflect a mixed portfolio of financial assets***

- 2.77 The choice of the legal basis for setting the discount rate and the subsequent actual setting of the rate do not appear to fall within the definition of regulation.<sup>13</sup> Nevertheless, as the Lord Chancellor and his counterparts are proposing to consider changing the discount rate, any new discount rate can subsequently be taken into account by the court when determining settlements and the defendants in those cases are likely to include businesses. As such, impacts on businesses may be generated by the possible changes identified in Option 1. If OIOO were to be applied to the

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<sup>13</sup> "A rule or guidance with which failure to comply would result in the regulated entity or person coming into conflict with the law or being ineligible for continued funding, grants or other applied for schemes. This can be summarised as all measures with central force imposed by central government and other schemes operated by central government." One-In, One-Out (OIOO) Methodology July 2011 para 13.

Option 1, the resulting impacts on businesses would depend on what the final rate would be as explained below.

- 2.78 Under Option 1A the discount rate is expected to increase relative to the base case and hence lump sum payments to claimants from defendants are expected to decrease. This would represent a transfer from claimants to defendants. While reduced lump sum payouts would benefit businesses, such as insurers who tend to be the defendants in the vast majority of personal injury cases, this is a transfer payment rather than an economic benefit and so is not relevant for the purposes of OIOO.<sup>14</sup>
- 2.79 Under Option 1B the discount rate would decrease relative to the base case and hence lump sum payments from defendants to claimants are expected to increase. This would represent a transfer from defendants to claimants and as with Option 1A is not relevant for the purposes of OIOO.

### **Option 2: Encourage greater use of periodical payment orders**

- 2.80 As for Option 1, encouraging greater use of periodical payment orders does not fall within the definition of regulation, although this will ultimately depend on the specific details of this policy. The greater use of periodical payment orders will impact on business defendants including insurers. If OIOO were to be applied to Option 2, the resulting impacts on businesses would be as explained below.
- 2.81 Under Option 2 the main impact on defendants including insurers would be a change in cashflows. Rather than an upfront lump sum, compensation for future losses would be paid out over time.
- 2.82 Overall the compensation paid out would be the same, but compared to the base case defendants would have the use of some additional funding in the short term. It is assumed that this would benefit defendants as the cost to defendants of bearing investment risks would be lower than the price they would pay to claimants to bear these risks via the discount rate. In general, defendants such as insurers might be expected to pool funding across a number of personal injury claimants and potentially achieve a higher return than the discount rate at no additional risk.
- 2.83 Defendants may incur some additional administration and investment management costs from the use of periodical payments. However, defendants may gain if the cost of managing investments is lower for them than the costs for claimants (which defendants may cover as part of the settlement).
- 2.84 There may be an impact on financial advisers as a result of reduced demand from claimants although this may be offset by increased demand from defendants. These impacts are considered to be a secondary effect of this proposal and are therefore not relevant for the OIOO assessment.
- 2.85 Overall, the impact on defendants would depend on the extent to which they can bear investment risks and management costs at lower costs than claimants compared to any additional administration costs they may incur from the use of periodical payments. It is not currently possible to quantify these costs as data is not available on defendants' investment decisions or the administrative costs of periodical payments. As such, if OIOO were to apply, Option 2 is provisionally assumed to have zero net impact on businesses.
- 2.86 The consultation accompanying this IA seeks to gather evidence on what the overall impact on defendants, including insurers might be of greater use of periodical payments.

## **3. Enforcement and implementation**

- 3.1 The assumption for the proposal is that the appropriate parameters will be used by the Lord Chancellor and his counterparts when they come to decide, independently, what the discount rate ought to be. They will also decide independently when the new rate should apply.
- 3.2 The discount rate is specified so that it may be applied by the courts in the award of damages. The courts can apply a different rate if occasion requires. The application of the rate is not enforced, although it is to

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<sup>14</sup> Only economic costs and benefits are relevant for the purposes of assessing the One-In One-Out implications. See e.g. The One-in, One-out (OIOO) Rule: Frequently Asked Questions Departmental Guidance (July 2012) “OIOO focuses on the direct net cost to business/civil society organisations. Direct economic benefits to business will be netted off the direct economic costs to business to calculate the INs and OUTs”. Transfer payments are not economic costs or benefits. See e.g. HM Treasury Green Book p21 “Transfer payments may change the distribution of income or wealth, but do not give rise to direct economic costs.”

be expected that the parties to a dispute will be attentive to the application of the rate as it will affect the sum of money to be paid or received.

## 4. Specific impact tests

### *Equality Impact Assessment*

4.1 We have identified that the possible changes under consideration may have equality impacts and that further information is required to assess them. We have identified a range of equality stakeholders and have sought their views on the issues generated in the consultation paper accompanying this IA.<sup>15</sup>

### *Competition Assessment*

4.2 We have carried out a competition assessment and do not anticipate that the choice of the parameters for setting the discount rate will have any competition impact. Any effect will be indirect and will depend on the nature of the change to the parameters for setting discount rate (if any). The choice of parameters and the rate will apply to all businesses irrespective of their size as any business found liable for a personal injury must pay full compensation to the claimant. We have reached the same conclusion in relation to the possible measures that might be taken to encourage the use of periodical payments.

### *Small Firms Impact Test*

4.3 We have considered the impact of how the discount rate will be set on small firms. As the parameters do not regulate any activity of small firms any effect of the choice of parameters on them will be indirect.

4.4 We do not consider that the choice of parameters will affect the operations or performance of small firms or affect them differently from other businesses. This is because the discount rate is applied by the court to its quantification of an established legal liability in personal injury cases. The application of the rate allows the court to take account of the accelerated payment inherent in the lump sum payments of damages, thereby preventing under- or over-compensation. This precludes any alternative approach or exemptions being applied in cases involving small firms.

4.5 Making enquiries of small firms as to the possible effect of a choice of parameters before the consultation paper had been published would be premature. We will however seek views about any effect there may be on small firms in the consultation paper and will carry out a small firms survey as part of the consultation process to ensure that the effect of the choice of parameters on small firms is properly understood and any possible alternative approaches for small firms properly considered.

4.6 We propose a similar approach in relation to potential measures to encourage the use of periodical payments. We do not consider that such measures would be likely to regulate any activity of small firms or affect them any differently from other firms. Periodical payments are simply a way of making full compensation for future loss through the payment of a series of payments. If any small firms are called on to make such payments as a result of a court case, the court will have decided that the payments are secure. This will inevitably mean that they are being paid by the small firm's insurer rather than the small firm.

### *Environmental Impacts*

4.7 We do not anticipate any major environmental impacts from the choice of the parameters of setting the discount rate, changing the rate or encouraging the use of periodical payments. This exercise has no physical consequences. The setting of the rate will only affect the level of lump sum damages payments in personal injuries cases. It will not generate any environmental consequences.

### *Health Impact Assessment*

4.8 We do not anticipate any significant impact on human health or the demand for health and social care services in the UK as a consequence of the choice of the parameters used for setting the discount rate. The choice of parameters and the choice of rate are intended to support the fulfilment of the objective of full compensation achieved by return on investment made at an appropriate degree of risk. If the parameters chosen to set the rate cannot produce an appropriate rate or the rate is inappropriately set notwithstanding the parameters chosen is appropriate there may be under-

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<sup>15</sup> See paragraphs 108–117 of the consultation paper.

compensation. This could have health and social care consequences for the individual as he or she may not be able to afford appropriate care. The inability to buy care may mean that the person is reliant on public provision. As we expect both the parameters and the rate to be appropriate, we consider the chance of this occurring to be small. The result of our initial health screening test is that a full health IA is unnecessary. We have reached the same conclusion in relation to measures to encourage the use of periodical payments. Indeed periodical payments should ensure that funds are available for planned care and treatment with greater certainty than is the case of lump sum settlements.

#### *Human Rights*

4.9 The consideration of a range of possible parameters used for the setting of the discount rate has been subjected to a Human Rights screening to ensure that they are compliant with the Human Rights Act 1988. We do not anticipate that steps to encourage the use of periodical payments instead of lump sums to provide full compensation would have any adverse Human Rights consequences.

#### *Justice Impact Test*

4.10 Justice impacts have been considered and as the choice of parameters for the setting of the discount rate is not expected to increase the volume of cases that will go through the court system, it is not expected that the proposal will have a significant justice impact. Nor will the change of the rate occasion the court or the parties any additional work where the new rate is applied. In those cases where the rate is challenged as inappropriate for the case in question – which we understand are very few – the party making the challenge will need to convince the court another rate is appropriate. This is the situation at present and the amount of work required to challenge a new rate (and underlying parameters) is unlikely to be much different from the work required to challenge the present rate. We do not expect that the encouragement of periodical payments would make court cases any more complicated or have any other material justice impact.

#### *Rural Proofing*

4.11 We have carried out a rural proofing assessment and do not anticipate that any rural impacts will be different from the rural impacts (if any) of the present rate and parameters. This is because the actuarial tables used to calculate damages do not distinguish between rural claimants and others. Nor do we expect that the encouragement of periodical payment orders would have any particular rural impacts.

#### *Sustainable Development*

4.12 We do not anticipate any major sustainable development impacts from the selection of the appropriate parameters for setting the discount rate, the consequent setting of the rate or any encouragement of the use of periodical payments. The impact of any consequent change in the discount rate may however have the indirect effect of altering insurance premiums.

## **Annex 1: Post Implementation Review (PIR) Plan**

### **Basis of the review:**

Legal duty to review the appropriateness of the rate on an ongoing basis. It is implicit in this duty that the parameters used to set the rate should be appropriate. The parameters used to set the rate are therefore also subject to review on an ongoing basis. Nonetheless a review can be undertaken at a fixed date. If periodical payments are encouraged then a review of their level of use and efficacy would be desirable.

### **Review objective:**

Proportionate check

### **Review approach and rationale:**

The review will consider whether the parameters chosen to set the discount rate as a result of the consultation has produced an accurate discount rate in accordance with section 1 of the Damages Act 1996. It will also consider whether periodical payments have increased and are effective.

### **Baseline:**

A discount rate of 2.5% set on the basis used by Lord Irvine, the then Lord Chancellor, in 2001 and the current level of periodical payments.

### **Success criteria:**

The absence or failure of any challenge by way of judicial review to the rate or the basis on which it was set and an increase in the use of periodical payments.

### **Monitoring information arrangements:**

The financial information necessary for monitoring the appropriateness of the discount rate is publicly available. Information on the take up of periodical payments would require stakeholder engagement.

### **Reasons for not planning a review:**

N/A.