Conclusion of the Lord Chancellor's first review of the discount rate under the Civil Liability Act

The decision: the discount rate set under the Damages Act to be altered from minus 0.75% to minus 0.25% effective from 5th August 2019.

On 15th July 2019, the Lord Chancellor announced the outcome of the first review of the discount rate under the Civil Liability Act. The announcement came as a relief to most claimant advisers, with few expecting the maintenance of a negative discount rate in England and Wales (or at least for the correct reasons).

That is in no way to suggest that a positive discount rate would have been appropriate in our view. Indeed, it is our view that minus 0.25% remains too high.

We had feared not just a positive rate, but a rate outside of the previous 2017 GAD estimate of between 0% to 1%.

So, what were we worried about?

We were concerned that:

1. The equity content of the portfolio would be outside of that which we would consider to be 'low risk'; boosting nominal and, therefore, real returns;
2. The RPI would be abandoned in favour of the CPI and, given that the 2017 GAD estimates were RPI-linked 'real' returns, this would boost the real return on the portfolio by between 0.7% and 0.9% per annum; and
3. The allowance for investment charges and taxation would be too light, increasing the net returns on the portfolio.

In all three regards, we had good reason to be concerned.

With regard to our first concern, the 'central' model portfolio has 42.5% invested in 'higher risk/growth assets', which we would not consider to be 'low risk'. Indeed, it is not just us that considers this to be the case.

The 'Summary of Responses to the Call for Evidence' sets out the following:

> *One respondent (of the 16) made an analogy between the personal injury claimant's lump sum and a pension fund and suggested that the Lord Chancellor would have a role similar to that of professional trustee of a pension fund. In this context, Lord Chancellor would have to consider the principles of the Purple Book which would require a significantly lower risk portfolio than those proposed in the Call for Evidence*

This was our response, which set out:

> *The state-backed Pension Protection Fund (PPF) publishes detailed annual statistics on UK defined benefit pension schemes[1], including the table overleaf which provides clear evidence of the significant shift towards bonds and away from equities since 2006.*
>
> *Only portfolio (i) (at para 45 of the Call for Evidence) has an asset allocation similar to that of defined benefit pension schemes in 2018.*
>
> *Furthermore, the position of claimants is to be distinguished from these defined benefit pension funds because a lump sum provides a single cash flow rather than the multiple cash flows that would be received in the pension funds. The position is therefore closer to that of the PPF itself.*
>
> *The PPF invests primarily in cash and bonds, with 40% in liability hedging instruments[2], 41.5% in return seeking assets[3], 12.5% hybrid assets[4] and 6% cash. Not all of these asset classes are accessible to individuals. It can be observed that the asset allocation of the PPF bears resemblance to that set out in our response to Q1, which is based on Chapter 4 of the Report.*
>
> *Therefore, evidence from the pensions world leads us to the same conclusion as our response to Q10, i.e. all three proposed model portfolios fail to meet the high level objective because they are too risky for the primary purpose of liability matching in the context of individual claimants.*

The table referred to is set out overleaf.

With regard to our second concern, it is clear that all returns have been measured against the CPI. As feared, this increases the real return expected from the model portfolios.

This was not a surprise. It was stated in GAD's terms of reference that the CPI should replace the RPI and we wonder how long it will now be until the RPI is replaced by the CPI as the default measure for periodical payments in the Damages Act. Such a 'replacement' would, due to the wording within the model Schedule to the Order for RPI-linked periodical payments, mean that future increases applied to those existing Orders would be CPI-linked and not RPI-linked.

With regard to our third concern, the total allowance made in respect of taxation and charges was 0.75%.

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1 The Purple Book.

2 UK conventional and index-linked gilts, interest rate and inflation swaps, UK gilt repurchase agreements, exchange traded derivatives and high-grade sterling corporate bonds.

3 Global government bonds, public equity and alternatives.

4 Assets which are capable of both liability matching and return seeking objectives.

Figure 7.2 | Weighted average asset allocation in total assets

Year/ *The Purple Book* dataset	Asset class							
				Breakdown of other investments				
	Equities	**Bonds**	**Other investments**	***Property***	***Cash and deposits***	***Insurance policies***	***Hedge funds***	***Miscellaneous****
2006	61.1%	28.3%	10.6%	4.3%	2.3%	0.9%	n/a	3.1%
2007	59.5%	29.6%	10.9%	5.2%	2.3%	0.8%	n/a	2.5%
2008	53.6%	32.9%	13.5%	5.6%	3.0%	1.1%	n/a	3.8%
2009	46.4%	37.1%	16.5%	5.2%	3.9%	1.4%	1.5%	4.5%
2010	42.0%	40.4%	17.6%	4.6%	3.9%	1.4%	2.2%	5.4%
2011	41.1%	40.1%	18.8%	4.4%	4.1%	1.6%	2.4%	6.3%
2012	38.5%	43.2%	18.3%	4.9%	5.1%	0.2%	4.5%	3.6%
2013	35.1%	44.8%	20.1%	4.7%	6.7%	0.1%	5.2%	3.5%
2014	35.0%	44.1%	20.9%	4.6%	6.1%	0.1%	5.8%	4.3%
2015	33.0%	47.7%	19.3%	4.9%	3.5%	0.1%	6.1%	4.7%
2016	30.3%	51.3%	18.4%	4.8%	3.0%	0.1%	6.6%	3.8%
2017	29.0%	55.7%	15.3%	5.3%	-0.9%	0.1%	6.7%	4.1%
2018	27.0%	59.0%	14.0%	4.8%	-2.5%	0.1%	7.0%	4.6%

Source: PPF

* Other alternative investments excluding hedge funds. 3.4 per cent of the total 2018 figure relates to annuity policies held in the schemes' names, sometimes referred to as 'buy-ins'.

The weighted average proportion of assets held in cash and deposits being negative represents a number of large schemes with significant negative cash holdings which are likely to be related to investments such as swaps and repurchase agreements.

Note: figures may not sum to 100 per cent or the 'other investments' total due to rounding.

In *The Purple Book 2018* dataset, the proportion invested in bonds rose while the proportion in equities fell, continuing the long-term trend.

In larger cases (£3million), where the discount rate impacts the most, GAD acknowledged that the 'tax drag' was 0.5% per annum alone, with a 0% drag in cases of £100,000. Whilst not disputing these figures, it is our opinion that in the most catastrophic cases, the impact of taxation on real returns has been under-estimated.

In respect of investment charges, the 'Summary of Responses to the Call for Evidence' states:

> *The final group of eight respondents, mainly representing claimants, provided estimates based on actual experience for investment management costs which generally ranged between 1.5-2% although one estimate went as high as 2.1-2.4% while another quoted an upper bound of 2.3% (although it claimed to try and keep the figure down to under 2% where possible). Thus, one claimant lawyer suggested an average figure of 1.5% (with a range of between 1.1-1.9%) while a financial advisor suggested 'at least' 1.6% even for a low risk, cautious, globally diversified portfolio. The remainder all suggested the 1.5 to 2% range.*

Both PFP and FOCIS (the latter based on a survey of investment managers) quoted a range of 1.5-2% with the latter suggesting a mean of 1.78% which it confirmed was consistent with their clients with portfolios worth up to £1.5m. A financial adviser also suggested a range of 1.5 to 2% for smaller, fairly actively managed portfolios.

However, the 'Government Actuary's advice to the Lord Chancellor on the personal injury discount rate' concluded:

Based on the responses to the Call for Evidence and my subsequent meetings with financial advisers, the costs for this component of advice would be around 0.25% to 0.5% pa.

It must be noted that the analysis and modelling of investment performance I have undertaken is based on (i) an asset allocation that remains constant throughout the entire period (ii) benchmark or passive returns under each asset class and (iii) an investment objective that remains unaltered throughout. I have not explicitly modelled enhancements to these returns from active management of each investment mandate, of the asset allocation or of the regular drawdown of funds, all of which might result from the employment, at a cost, of persons or firms that are skilled in providing advice in these areas.

It remains our view that the assumptions on which the analysis is based are inappropriate for personal injury claimants. Active management is not used by our clients to generate out-performance (alpha as it is known), but manage down-side risk. Therefore, it is our opinion that passive-only investment is inappropriate and active management does not create additional returns; meaning it is a pure cost.

As a result, as feared, the total allowance for taxation and costs has been significantly under-estimated, increasing assumed net returns.

Consequently, based on the same approach applied by GAD in 2017, the above CPI-inflation and net (of taxation and investment charges) discount rate would have been 1.25%.

However, it was the application of the two adjustments for 'damage inflation' and 'sensitivity' that made all of the difference; those being 1% and 0.5% respectively.

Set out below is an overview of the decision and our immediate thoughts.

The Lord Chancellor's (LC) Reasons and the Government Actuary's (GAD) Advice:

- Advice from GAD is based on forecast investment returns over an average duration of 43 years, which the LC accepts is a reasonable period.
- GAD forecasts are based on the asset allocation from the central portfolio overleaf, which the LC considers to be an appropriate one:

Allocation	Cautious	Central	Less-cautious
Lower risk / matching Assets	70%	57.5%	45%
Cash	12.5%	10.0%	7.5%
Gilts	35.0%	30.0%	22.5%
Corporate bonds	22.5%	17.5%	15.0%
Higher risk / growth assets	30%	42.5%	55%
Equities	22.5%	32.5%	42.5%
Alternatives	7.5%	10.0%	12.5%

- GAD forecasts a prospective return of CPI+2%, and explicitly states an expected improvement in forecast returns by the time of the next review in five years. No allowance has been made for that prospect in the figure of CPI+2%;
- This is the expected return from a passively invested portfolio, which has a static asset allocation over the entire 43-year duration;
- GAD estimates the impact of tax and charges (including IFA fees) on such a portfolio to be in the range 0.6% to 1.7%, and assumes an allowance of 0.75%, which the LC considers to be reasonable;
- GAD states the expected future growth in earnings will be 2% above CPI. Since not all future losses or expenses are earnings-based, GAD advises an assumption of 'damage inflation' at 1% pa, which the LC accepts.
- Therefore, GAD recommends a DR of +0.25%;

% pa above CPI	Representative claimant
Expected gross return before deductions	CPI+2.0% pa
Deduction for tax and expenses	0.75% pa
Deduction for damage inflation	1% pa
Expected net return	**CPI+0.25% pa**

- However, LC considers this to be a starting point, and that the risk of under-compensation would be too high at this level, with only a 50% chance of achieving full compensation. Furthermore, GAD's advice concludes with the warning that there is a significant risk that claimants will not achieve the median returns shown in GAD's analysis.
- LC considers it prudent to build-in an allowance of 0.50% for sensitivity to GAD's baseline assumptions, particularly in relation to shorter duration awards; hence the resulting figure of minus 0.25%.

<u>What About the Rest of the UK?</u>

Coincidentally (or not), the deductions for tax and charges, and for other factors, are identical to those in the Damages (Investment Returns and Periodical Payments) (Scotland) Act 2019. However, the Scottish model portfolio, which is set out in the statute, has a higher allocation to 'matching assets', which implies lower returns than the central portfolio.

Other things being equal, one might therefore expect the discount rate in Scotland to be less than minus 0.25%. Politics might of course make things less than equal.

In Northern Ireland, the discount rate remains at 2.5%, and therefore significantly out-of-step with the rest of the UK.

<u>Damage Inflation</u>

This is a peculiar and unexpected development; we had anticipated that the RPI would simply be jettisoned in favour of the CPI as the preferred inflation measure. Instead, we now have a hybrid, allowing for expected earnings growth (of CPI+2%) on half of the future losses (or 50% of earnings growth on the lot).

This is therefore the broadest of brushes used in the attempt to stave-off the effects of future inflation (whether earnings or prices) on future loss and expense.

That said, it remains the case that the only way to seek 100% of future earnings growth is by way of a periodical payments Order (to which a claimant has no right).

Additionally, it is unlikely that 50% of a lump sum award, where periodical payments are received in respect of future care and case management, loss of earnings and future Deputyship costs (for example[5]), would be earnings related.

This gives rise to the potential of additional benefit for those who receive periodical payments for earnings related losses and expense:

1. They receive 100% of actual future earnings growth above CPI (whether at 2% or more), rather than 50% of an assumed 2% real level; and
2. Their discount rate for expenses that are more likely to rise in line with CPI inflation is 1% less than it would otherwise be; that is a material 'windfall' over a long lifetime.

<u>Accommodation Claims</u>

Ever since the original decision to set a negative discount rate, there has been uncertainty about how to assess future loss in relation to additional capital tied-up in property, since the *Roberts -v- Johnstone* (*RvJ*) calculation produced a nil award at the previous discount rate.

However, there is an apples and pears comparison here, because the old discount rate was based on a risk-free rate of return, whereas the new one is not. The multiplicand in the *RvJ* calculation is supposed to represent a risk-free rate of interest, therefore it cannot be appropriate to use the new discount rate in the calculation.

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[5] We accept that other elements of the claim might be predominantly earnings driven, such as therapies, but as the cost is a 'charge rate' and not an 'earnings level' it is more difficult to calculate the earnings uplift.

However, other things being equal, a risk-free interest rate would be lower than the new discount rate, and therefore still produce a nil award.

Even if it were appropriate to disaggregate the expected future returns modelled by GAD, so as to isolate returns on gilts, for example, and then make no adjustment for tax and charges, or 'damage inflation' or other factors, the likely outcome would still be a nil award.

As can be seen from the GAD forecasts summarised in the table below, the expected real return on gilts is negative at all durations up to and including 50 years into the future.

It is clear that the *RvJ* issue has not been resolved by the new discount rate; if anything, it has become even more fractured.

Median money weighted real return % pa in excess of CPI	5 years	10 years	15 years	20 years	30 years	40 years	50 years
Nominal gilts	-2.8%	-2.2%	-1.9%	-1.5%	-0.9%	-0.4%	-0.1%
Index-linked gilts	-3.3%	-3.2%	-2.7%	-2.2%	-1.3%	-0.8%	-0.4%
Investment grade credit	-0.1%	-0.4%	-0.2%	0.0%	0.4%	0.8%	1.1%
UK equities	2.2%	2.6%	2.8%	2.9%	3.0%	3.0%	3.1%
Overseas equities	2.6%	2.9%	3.0%	3.1%	3.2%	3.3%	3.4%
Cash	-1.2%	-0.9%	-0.6%	-0.4%	0.0%	0.2%	0.4%

<u>Split Discount Rate</u>

GAD put forward the case for a split discount rate, with cash flows arising during the first 15 years to be discounted at (broadly) 0.5% per annum less than a single discount rate, and those arising thereafter to be discounted at 0.5% more.

The LC accepted that this may be an appropriate solution but requires it to be put to consultation before being given consideration at the next review.

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