HOUSE OF COMMONS

Justice Committee

Oral evidence: Pre-legislative scrutiny: draft clause on personal injury discount rate, HC 374

Wednesday 1 November 2017

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Watch the meeting

Members present: Robert Neill (Chair); Mrs Kemi Badenoch; Ruth Cadbury; Alex Chalk; Bambos Charalambous; David Hanson; John Howell; Gavin Newlands; Laura Pidcock; Victoria Prentis; Ellie Reeves.

Questions 1 - 110

Witnesses

I: Richard Cropper, Personal Financial Planning Ltd; Brett Dixon, President, Association of Personal Injury Lawyers; Professor Victoria Wass; and Martin White, Institute and Faculty of Actuaries.

II: Huw Evans, Director General, Association of British Insurers; Emma Hallinan, Director of Claims and Legal, Medical Protection Society; and David Johnson, Forum of Insurance Lawyers.

III: Lord Keen of Elie QC, Ministry of Justice Spokesperson.

Written evidence from witnesses:

- Personal Financial Planning Ltd
- Association of Personal Injury Lawyers
- Professor Victoria Wass
- Institute and Faculty of Actuaries
- Association of British Insurers
- Medical Protection Society
- Forum of Insurance Lawyers
- Ministry of Justice

Examination of witnesses

Witnesses: Richard Cropper, Brett Dixon, Professor Wass and Martin White.

Chair: Good morning everyone. Welcome to our evidence session on the pre-legislative scrutiny of the Government's proposed changes to the personal injury discount rate. Before we go to our first panel of witnesses we will, as usual, deal with declarations of interest.

I am a non-practising barrister. I am also consultant to a law firm and, in that capacity specifically, I know personally Mr Johnson, who will be giving evidence in the next panel, as he is a partner in that firm.

Victoria Prentis: I am a non-practising barrister.

Alex Chalk: I am a barrister.

Ellie Reeves: I am a non-practising barrister. Professor Wass, although we have not met, I was one of the lawyers as part of the construction industry vetting information group litigation that instructed you.

Bambos Charalambous: I am a non-practising solicitor.

Q1 **Chair:** All the witnesses have given us written evidence. We are grateful to you all and your organisations for that. I will ask our first panel to introduce yourselves and your organisations for the record.

Martin White: I am Martin White, representing the Institute of Actuaries.

Professor Wass: I am Professor Victoria Wass, a labour economist at Cardiff Business School.

Brett Dixon: I am Brett Dixon, president of the Association of Personal Injury Lawyers.

Richard Cropper: I am Richard Cropper, of Personal Financial Planning.

Q2 **Chair:** If we go back to what is supposed to be the principle, in the Wells case in the House of Lords in 1998, the argument has always been that the objective of the process is to leave people in the same position as they would have been in money terms. It is worth saying that you can never compensate for the actual loss of life chances in some respects, but, in money terms, the phrase used is "neither worse-off nor better-off" than they would have been but for the incident that gave rise to the injury.

Isn't the reality that under any framework, just by the nature of things, although that is an objective, there will always be some claimants who are likely to be undercompensated and some who are likely to be overcompensated compared with their loss, because the discount rate is one of a number of other variables? There are accommodation costs and what you can recover from that, and many other things. What is your take? Will the proposed legislation reduce both the proportion of

claimants being overcompensated, as is suggested, and the level of overcompensation? Is that of itself unreasonable or not?

Richard Cropper: It is important to remember where a claimant starts, even on a no-risk basis. At present, under the current discount rate of negative 0.75%, following the case of JR, the claimant gets to recover zero in respect of their future accommodation need. When I sit down with a client on day one, post settlement, to talk about their future planning, they start off with insufficient capital in their pot to meet all their future needs. In addition, for all the reasons that were dealt with in the Thompstone litigation, care costs and earnings rise over the long term at a faster rate than prices. The assumption in Wells is that the future need will be inflation-proofed by reference to the RPI.

The second issue is that, if my clients are going to suffer, in reality, real earnings growth of between 1% and 2% per annum over the long term, they have a choice. If they have a 40-year or 50-year life expectancy, they can probably achieve about 70% of their need because of the compounding effect of their costs increasing above inflation. In addition, the discount rate is set at a three-year average. I wish I could buy gilts at the price they were three years ago. As a result of the on the spot rate of the basket on 20 March of this year when the new discount rate of negative 0.75% came into force, the actual spot rate on that day was negative 1.69%, so the claimant was already being undercompensated in all those three areas. In addition to that, the projected mortality tables that form Ogden 7 are out of date and underestimate average life expectancy.

Q3 **Chair:** I understand. We are going to try to get through this fairly sharply. Some of it is quite technical and is picked up in the written evidence. You are a specialist in the investment field. In reality, nobody simply puts their investment into gilts.

Richard Cropper: Nobody would, because they do not start off with enough, so they cannot generate a real return. They guarantee themselves undercompensation if they do so. They are forced to take risk, even on the no-risk assumption.

Q4 **Chair:** But it is also legitimate perhaps to make sure that the rate reflects actual investment behaviour rather than the theoretical—the "We stand back and do not take an interest" view of the world, perhaps.

Richard Cropper: When we advise claimants about investment risk, it is to meet their need, not how much risk they are prepared to take and then maximise return. It is the other way round.

Q5 **Chair:** How should the judgment come to an assessment of those sorts of conflicting needs—the under and overcompensation; what the risks are and how you get to a fair position?

Professor Wass: I start from the position that I do not think there is overcompensation. I will start with my conclusion and then work back,

because that is quite a helpful way to do it. My conclusion is that, if you want to meet the 100% compensation principle, you have no choice other than to base the discount rate on the investment that delivers the least risk, if we assume that claimants are risk averse. It is not controversial to assume that claimants are risk averse. If anybody wants to bring that up, I am happy to answer it, but I am going to assume that everybody agrees that claimants are risk averse, and that means that they prefer a safe investment to an investment that has a variable return.

Q6 **Chair:** There is still a risk, whether they are very risk averse or whatever.

Professor Wass: That is right. The difference between having a certain equivalent and an expected value that could change, which is based on risk, is the risk premium. The risk premium will be larger, so the larger your risk aversion. By moving from a discount rate based on ILGS to a mixed portfolio, the claimant is paying that risk premium over to the defendant, so they are going to be worse off. With this Bill, you are only correcting an inequality if you think that the claimant should not have that risk premium to start with. They are actually having to pay over that risk premium, so they are worse off.

Q7 **Chair:** The evidence that we saw from the insurers' lawyers said that the Government Actuary estimated that about 95% of claimants were overcompensated by 35% on average. Mr White and Mr Dixon, I want to bring you in. What do you make of that? Do you agree with that proposition and those figures, or is there something else?

Martin White: I am afraid we would not look at the question in that way.

Q8 **Chair:** Tell us how you would look at it, and why.

Martin White: What we would do is to say, "What is the most market-consistent approach?" The most market-consistent approach is one that looks at the assets that most closely meet the needs. It will not precisely meet the needs, because you have things like earnings, but they are the best available and you have to make a judgment about how to adjust them. That would be our start point.

Q9 **Chair:** Mr Dixon, what are your thoughts?

Brett Dixon: The first thing is that you have a compensation principle of 100%. That is the starting point. The use of gilts is the methodology; that is what it is. It is never something that the court envisaged would be directly invested in. It was the best way available to the court in Wells to ensure that the 100% compensation principle was met.

If you move away from using the system that underpins it, you run the risk of undercompensation. As a practitioner, I do not see people behaving like they have a lottery win or money that they can freely invest. What they and their families actually have is a pot of money that has to last them for the rest of their lives. They have no other way of

making any money, earning or otherwise, and their biggest focus is making sure that that money is available to meet their need. If they do not have the money available at the end—for example, in relation to care, because something has happened, say, they have invested it in a less than low risk way—the state picks it up, rather than the insurance company that took the premium for that risk. For me, this is all about how society should treat people who are injured and how we deal with people when there is negligence, when somebody has been catastrophically injured, and we have a system whereby there is an insurance premium and insurance policy available to meet the risk that eventuates.

Q10 **Chair:** Given that there is acceptance about the 100% principle being something that people wish to maintain, and you make the point that the mechanism of reference to a gilts risk level was the best available at the time of Wells in 1998, is that still necessarily the best mechanism, or is there another mechanism that still achieves that principle?

Richard Cropper: One of the difficulties with the 95% overcompensating by 35% is that the basis on which GAD was asked to generate those two percentages does not reflect the evidence in the questionnaire. We are talking about £10,000 a year need. I do not have clients whose total needs are as low as £10,000 a year. It underestimates the impact of taxation. It underestimates the impact of investment advice and investment cost. It was RPI-linked, so it completely ignores the real earnings issue, which is fundamental. The submission by Chris Dakin sets that out very clearly. It is over a shorter duration than the duration on which the questionnaire was based.

When you take into account those real-world risks, if you set the discount rate by reference to what claimants are currently doing but you still do not compensate them properly for accommodation and still do not take into account real earnings growth, they will still have to take more risks than the risks you are now assuming. Three years down, when the panel are appointed, what they will see is that even more risk then has to be taken.

Q11 **Victoria Prentis:** I want to drill down a little bit. We accept that claimants are not ordinary investors. Could you give us a bit more evidence about what actually happens? Defendants' lawyers say there is reluctance to provide evidence of what claimants actually do with their pot of money, and this suggests that claimants take on more than very low risk, or that they spend the money on property perhaps. How would you respond to that?

Brett Dixon: It is quite simple, in a way. We are living in an arena now where we have a corrected discount rate of negative 0.75. For a very substantial period of time, it was wrong by a significant margin. Where does that leave you as someone who needs to meet your needs over a period of time? It leaves you having to take a risk. To look back historically at areas where someone may have taken risks to make their

money work to meet their need is the wrong question in a way. The real question should be: what can we do in terms of a mechanism that will deliver on somebody's needs now?

Richard Cropper: I act for 370 individuals post-settlement. My experience is that they are forced to take some risk, but it is also important to identify the other two things that they do. One is that they compromise their need. Secondly, they rely upon the state. Personal injury damages are disregarded from the means test for local authority funding. They are not taken into account for PCT funding. As long as they are entitled to direct payment, they effectively supplement their awards by relying on direct payments. They do not choose to do that; they have to fight for limited resources. The reality is that, when they have to attempt to achieve a 2.5% real and net return in the current environment, all of those three things are going on.

Q12 **Victoria Prentis:** Mr Cropper, what is the average rate of return you are achieving at the moment?

Richard Cropper: There isn't an average rate of return. For example, I have clients who unfortunately have less than 10 years to live. They have no capacity for loss, so they are in cash. Their cash is earning, at best, about half of 1% net of costs. Inflation is currently at 3%, or 4% if you measure it by the RPI. They are getting negative 3.5% real and net. They are being woefully undercompensated, even at the current discount rate.

A claimant with longer life expectancy has a bigger risk in terms of real need over time. They have more equities. We are measuring that at a point eight and a half years into what is now the third longest bull run in UK economic history; we are measuring it from a peak. The claimant who receives their compensation tomorrow cannot benefit from the investment returns that have been achieved over the last eight years. If we set the discount run by reference to past returns, which is the only way in a basket, we are going to find ourselves increasing the discount rate at the peak and reducing the amount of compensation to a claimant who then has the most investment risk—having to invest today at what feels like an elevated price. If we then get a collapse, there will be pressure on the discount rate to fall. We give the most money to those with the least investment risk, because they get to invest at the bottom. It is counterintuitive.

Q13 **Victoria Prentis:** When you do your pitch to potential clients, what do you tell them? What do you offer them?

Richard Cropper: We cannot. The reality is that what we are trying to do, over a lifetime, is match their need, and that changes. Their need will change on a daily basis. Tax rates change on a regular basis. I cannot say to them, "You should expect 6%." Is 6% real and net? We know what the benchmark is—the discount rate—but in many circumstances our advice to a client is, "You do not chase 2.5% real and net; you will have to compromise."

Q14 **Chair:** There has to be an average view taken somewhere, doesn't there, to set the value; otherwise you end up with a negative rate? How else would you do it?

Richard Cropper: An average is not helpful to an individual. If you do very well in the early years when you have most money, you get ahead of the game. If you do very badly—the judgment in Wells set out that, following the crash, it took 10 years to get back to parity in real terms—the claimant still has to spend his money providing for his needs. He will never make that back. The average does not help him.

Q15 **Chair:** What we are interested in is whether you are arguing for more than one rate, on that basis.

Victoria Prentis: Yes.

Richard Cropper: Duration is the most important aspect of risk.

Q16 **Chair:** Yes or no? Are you arguing for more than one rate?

Richard Cropper: There is an argument for more than one rate over duration, and more than one rate with regard to need.

Q17 **Victoria Prentis:** A sliding scale between length and—

Richard Cropper: Absolutely.

Q18 **Victoria Prentis:** Is there evidence that the higher discount rate forced claimants to put their money into higher risk investments, or do you feel that they did not, and that they carried on very safely investing and then relied on the state to pick up the slack?

Brett Dixon: In reality, it is probably a combination of both. You sometimes have clients whose sole focus is simply to maintain the pot of money. If they were not investing it when they were behind the curve, as Richard puts it, because they started off with the 2.5%, so it is difficult to make their money back, they will be the ones who end up needing more state help. There is a cost to the taxpayer, who is you and me, in relation to that. In my view, that is wrong when a premium has been taken to cover that risk.

Chair: Nobody seems to dissent from that.

Q19 **John Howell:** I want to turn to the question of high clinical negligence costs. Is that not linked to overcompensation in the way the system is worked?

Brett Dixon: In reality, the biggest driver in relation to any cost of dealing with negligence within the clinical area is the actual occurrence of incidents. It is as simple as that really. If the negligence does not happen, the cost is not there.

Q20 **John Howell:** Are you saying that the compensation of claimants has no impact at all?

Brett Dixon: It has an impact, but it is a very different one if there is no negligence, no claim and no compensation to be made.

Q21 **John Howell:** What is the impact?

Brett Dixon: The impact in relation to each individual case?

Q22 **John Howell:** No, the impact on high clinical negligence costs.

Brett Dixon: I would not ordinarily see what I would term high clinical negligence costs, to be perfectly frank. The reality is that the cost drivers in that area relate to behavioural issues; not getting earlier admissions in relation to liability, or repetition of the same types of mistakes over and over again. They are what drive costs in that area.

Q23 **John Howell:** Would you say the same applies to high motor insurance costs?

Brett Dixon: In relation to high motor insurance costs, we are talking about something very different. We are talking about catastrophically injured people where either the parties have agreed that there has been negligence or the courts have found negligence. They are two very different things. They do not link in the way that is sometimes made out.

Q24 **John Howell:** Given that we are adding significantly to NHS costs, and that the OBR predicts a contribution to inflation, do we not need to do something about this? If so, what?

Brett Dixon: This is not the area where something needs to be done, or should be done. The guiding principle has to be to meet the needs of the individual who has been injured, regardless of who has injured them or how. The 100% compensation principle is a principle that has been with us in tort for very good reasons for a long period of time. We are dealing with people whose needs are very complex. This is not a contractual case where you have a couple of documents to look at. Human beings are complex by their very nature. Their needs are complex. They have needs in relation to accommodation, adaptation or hoists to get them in and out of baths. This is about trying to put somebody's shattered life back together. It is not the area to be looking at something like that, in my view.

Professor Wass: The question gets to the heart of what is driving the Bill: the cost to the NHS and the inflationary costs of car insurance. The Bill must be presented with that as the motivation—that the Government think that, for prudent fiscal and financial reasons, we should change the discount rate on the basis of a mixed portfolio. But we then cannot also claim that we are achieving the 100% compensation principle. You cannot have them both. You have to choose one or the other.

We depart from the common law of full restitution, on the basis that the Government think that the economy can no longer afford that 100% principle. You cannot have it both ways.

Q25 **Chair:** Is overcompensation a departure from the common law as well, if it happens?

Professor Wass: Yes, if it happens. I think the argument is that it has not been proved.

Q26 **Chair:** I take your point on that, but in principle, it applies.

Professor Wass: In principle, yes.

Richard Cropper: There is an interesting accounting issue, too, in relation to a change in the discount rate. In my experience of advising clients pre-settlement, the vast majority of clinical negligence claims that I deal with result in periodic payment orders for the largest elements of the claim. That has increased under the new discount rate. NHSR has been very successful in only offering periodical payments to claimants for the largest elements.

The discount rate that is applied to the reserve for those periodical payments is currently negative 0.8%. Changing the discount rate, which would have the greatest impact on care, case management and loss of earnings, if they continue to be paid in periodical payment terms, will not save the NHS a penny from an accounting perspective, because they will still be reserved for at negative 0.8%.

Q27 **John Howell:** Professor, I want to pick up where you left off. Was what you were describing what you meant when you said that the current legislation would lead to inefficiency?

Professor Wass: If the Bill went through, what are the inefficiencies?

John Howell: Yes.

Professor Wass: There is inequity when you transfer risk from the claimant to the defendant. There is also inefficiency, because claimants are going to be much less efficient than the Government and the insurance industry in bearing and managing that risk. Economists talk of that as a deadweight loss to the economy. Nobody gains from that. The economy loses from that. Managing risk is much better left with people who have expertise in managing risk, and they are not an injured claimant.

Q28 **John Howell:** What are your thoughts on the impact on the public sector equality duty?

Professor Wass: It comes back to what I was saying before. I do not think that you meet the 100% principle on the basis of the Bill—on the basis of a mixed portfolio. If you do not meet the 100% principle, that is unfair on claimants. The public sector equality duty requires statutory decision making and Government Departments to pay due regard to the impact of their policy on protected groups. Virtually all claimants are disabled. They would qualify as a protected group under the Equality Act.

Brett Dixon: There is also a very simple point related to the 100% compensation principle. If we move away from that, the cost of meeting the shortfall falls on the state.

Q29 **Chair:** One point that might be raised—I do not know if you have a view on this, Mr White—is that, for all the reasons set out, claimants in this situation will very often have a low risk tolerance, as it is sometimes put. People might say that a logical solution to that is to choose periodic payment orders, which of course would not be affected by the discount rate. Why does that not happen?

Martin White: Are you asking why it is that not everybody takes a periodic payment order?

Chair: Yes.

Martin White: We do not have the case knowledge to answer, but there are some general points that are worth making. One is that in Scotland you do not have a choice. Another is that there are some forms of liability for which the insurance cover is not unlimited. In a sense, if you get hurt by a motorist, you are in a better position than if you are protected by somebody who has cover with a limit on it. Those are two significant factors.

Chair: That is very helpful. Thank you.

Q30 **Bambos Charalambous:** Do you think the Government should define what a low risk investment is?

Richard Cropper: I have no idea how one defines what a low risk investment is, or where the border is between very low risk and low risk, where it becomes medium risk or where it is between medium and low. The beauty of index-linked Government stocks is that they do not predict the future. They are the future. That is the return you will get. With any other asset class, you have no idea; the crystal ball does not tell you. The most recent history is the least best estimator of future returns.

If we look back from where we are now, with equity markets at record highs, average investors will say it is a good time to invest. Professional investors will be far more wary because future growth is likely to be less. My principal concern with the proposed legislation is how you define what low risk is and how you measure that. It is an actuarial quandary.

Q31 **Bambos Charalambous:** If a claimant decides not to invest in gilts, should they be considered low risk? Should we still classify the investment as low risk?

Richard Cropper: It is their choice if they wish to take risk post-settlement. What they do with their damages post-settlement is a matter for the individual. I do not think it should be the basis for compensating them in the first place. If they choose to take investment risk, it will be to meet need. As an adviser, if I recommend to somebody that they take more risk than they need to be exposed to, and there is a fall in their

value, I will be successfully sued. Everything has to be driven by the need and not the return you get from taking risk. It is the wrong end of the telescope.

Q32 **Bambos Charalambous:** Should there be an upper limit on the proportion of equities in the low risk portfolio?

Richard Cropper: Yes. By their very nature, equities are the most volatile. They are also sat at record highs. They have material risk and they will generate volatility. They will generate gain opportunity, but they involve risk. Our clients do not want to be exposed to that risk. They are far more scared about the negative than the positive.

Q33 **Bambos Charalambous:** Even if you put the money into a bank account, there are risks with banks, as we have seen over the years.

Richard Cropper: The £85,000 limit.

Q34 **Bambos Charalambous:** On the issue of the discount rate and how it is set, do you think it should be set by politicians?

Richard Cropper: No.

Brett Dixon: I think we would all be in agreement on that. One of the things that you deal with as a lawyer, as a practitioner, is that you need to know when you need expert evidence in relation to different points. That is how cases are successful. It strikes me that on this occasion it is appropriate that the Lord Chancellor has expert advice and opinion, and that the Lord Chancellor, whoever it may be, has to follow that advice. It is given with the intention of making the decision correct, so for me it is very important that there is an expert panel that deals with it.

Q35 **Bambos Charalambous:** I am reflecting that once upon a time the Chancellor used to set interest rates, but they are now set by a board of wise people who meet on a regular basis to set interest rates. I do not know if that is something that could be done. My concern is that it has been 16 years since there has been a change. The proposal is that it should be every three years. With the volatility in the markets—we have not mentioned Brexit—do you think it should be an annual event, or do you think that three years is about right?

Brett Dixon: From a practitioner point of view, and as somebody who works in the civil justice system, with rules and things like that, if you do it on too short a period, you start to create problems in the civil justice system in relation to offers to settle between the parties. Then you take away a driver to settle cases, which saves court time and often leads to a better outcome. It needs to be something longer than a year. One way you could address the issue of whether you needed to do it more often is perhaps by not using a link to equities, because that takes away some of the volatility.

Richard Cropper: There is only a need for a panel if you move away from gilts. The same basis was applied to set the negative 0.75% rate

that was applied to generate the 2.5% rate. It is that you take the basket of gilts, you remove those with less than five years to redemption and you take the average redemption yield. There is a question about whether you take the three-year average or the one-year average. In our expert report to the Lord Chancellor, Dr John Pollock suggested that it should be one year rather than the three-year average, because of the nature of the curve. Clearly if the gilt yield goes the other way, one year will reflect that going upwards in a quicker manner. The rate sets itself, as long as somebody sets the rate.

Q36 **Chair:** But that does not deal with Mr Dixon's point. From a civil justice point of view, it would be desirable to take an average, because doing it on an annualised basis, if the rate sets itself, is too short a period.

Richard Cropper: The rate could be set every three years, for example. But you do not need the Lord Chancellor to set the rate. If you have defined the basis on which the rate is to be set, it is just a GAD calculation. They just do the calculation and it is set biannually.

Q37 **Bambos Charalambous:** It could be done by statutory instrument or something.

Richard Cropper: Absolutely.

Martin White: If the principle that we believe is correct is used—that you should take a market-consistent approach that deals with all the issues about the risk—what matters between the parties paying a lump sum or receiving it, to make it as fair as possible, is that the rate used should not be out of line with a market-consistent situation. If the markets were to move a long way—they moved a heck of a long way from +2.5% and it was frankly very unfair—or even if the rate moves by a quarter per cent, it can make a large difference to the valuation of a very long award. Our suggestion would be not that you should have a regular review, but that you should keep it continually under review, such that when it gets out by more than a quarter per cent you change it.

Brett Dixon: Offers within the civil justice system are a very important driver in relation to some of the behaviour we see and have talked about. We talked about a choice in relation to PPOs. For a claimant, there often is not a choice. If a defendant makes an offer to settle on a lump sum basis that puts the claimant at risk, they take it, or they run the risk and there is no PPO, even if a PPO might have been a far better way of delivering the damages.

Richard Cropper: It is my understanding—I am sure Mr White will have a view on this—that insurers are having to reserve for a PPO ASHE 6115 link, which is a care and case management periodic payment order, at somewhere between negative 1.5% and negative 2%. An insurance company has massive advantages over an individual claimant to make a lump sum and provide the same cash flow over the same individual's

lifetime. If they are reserving at that level, there is never an incentive to offer periodical payments, when the lump sum will always be cheaper.

Martin White: I don't disagree with that point. The point about the civil justice offer, while it is not an actuarial matter at all, is that it is one aspect of the compensation regime that we think may be stacked against the defendant. Are you going to have a dice thrown that means you have expenses against you? When we say PPOs are a good thing, the amount of PPO that is awarded or agreed on—the annual rate of care that is deemed appropriate—is itself subject to an offer like that. We are not sure that the adversarial approach is really the fair thing. It may cost society more.

Q38 **Bambos Charalambous:** If you could make a change in the Government's proposed legislation, what would it be? If you could propose one change to make it better, what would that be?

Professor Wass: You have to go for one or the other. You have to go for the mixed portfolio and move away from the 100% principle, or stick with the 100% principle and stay with ILGS returns.

Q39 **Bambos Charalambous:** The 100% principle is enshrined in the law as it stands.

Professor Wass: It is in the common law, but I think Parliament can legislate against it.

Martin White: Our response to that question would be that we do not think the proposed change in the law is appropriate or fair. If we had to make one technical change, it would be to use current rates rather than historical because that raises all sorts of issues. The other thing is the point I have just made, which is about the offers in court and whether that kind of approach is appropriate.

Brett Dixon: From my perspective, it is very simple. Claimants and defendants work very hard to work out between them what the need of an individual is, based on the evidence. We then shift to a decision being made by a claimant, where the rate is out of kilter, as it was for a long time, where they have to compromise on the need that has been worked out, rely on the state or take risk, which means that they might not have the money to meet the need in the future.

On the proposals from the Government, staying with the 100% compensation principle makes 100% sense to anybody who works in this area. It is also the case that the biggest problem we have seen has been lack of change for such a period of time. We welcome some mechanism that sees change regularly.

Richard Cropper: I echo all of that, but I would add that there is the potential of a missed opportunity to promote periodical payments. One of the submissions that my company made was to alter the part 36 rules so that the defendant was required to offer an equivalent periodical payment

when they made a lump sum offer. At least then we would be able to gather evidence as to whether claimants were rejecting periodical payments, as suggested, or actually, when faced with a direct choice on a like-for-like basis, whether a claimant would grasp those periodical payments with both hands, as I would expect.

Q40 **Bambos Charalambous:** Would that be an either/or, as an alternative—that you would get a part 36 as a lump sum or as a periodic payment?

Richard Cropper: Yes. My understanding is that that was echoed in the Stewarts Law submission, which was that the vast majority of offers they receive on a part 36 basis are lump sum only. That puts the claimant at risk in pursuing periodical payments, because he has to reject that and be exposed to potential litigation risk as a result. That seems unfair.

The other aspect relates to the indemnifiers—the MPS, the MDU and the MDDUS. There should be a mechanism to bring them within section 2(4)(c) of the Damages Act so that they can be considered reasonably secure. At the moment, they fall outside periodical payments because they have no means to offer reasonably secure periodical payments.

Chair: That is the point. It has to be secure. I understand that point. It is well made. Thank you all very much for your evidence to us today and for the written evidence that preceded it. We are very grateful for your time and your trouble. It is much appreciated.

Examination of witnesses

Witnesses: Huw Evans, Emma Hallinan and David Johnson.

Q41 **Chair:** Good morning, ladies and gentlemen. Thank you very much for coming to give evidence to us and, as I said to the previous panel, for the written evidence that I know your organisations have submitted. Would you please introduce yourselves and your organisations for the record?

Huw Evans: My name is Huw Evans. I am the director general of the Association of British Insurers.

David Johnson: I am David Johnson. I am a partner at Weightmans solicitors and I am here to represent the Forum of Insurance Lawyers.

Emma Hallinan: My name is Emma Hallinan. I am the director of claims policy and legal at the Medical Protection Society.

Q42 **Chair:** Mr Evans and Mr Johnson, we have looked at your evidence. It states that there is no objective evidence of claimants being undercompensated when the discount rate was at its previous level of 2.5%. What evidence do you have that claimants are now overcompensated?

Huw Evans: We certainly accept, as we did in our submission, that the principle of 100% compensation is absolutely the right one to work from.

Parliament got it right 21 years ago when it passed the Damages Act, and that principle should be at the heart of any reforms.

Q43 **Chair:** That seems to be generally accepted by everyone.

Huw Evans: It is worth stating, given that our panels may not be in agreement on every subject matter, that we are in agreement on that. You are right that there is a lack of evidence provided by those who actually advise and look after the finances of people who are in this unfortunate position. There is simply a lack of evidence that has been put forward to this inquiry and to other inquiries about what the financial position of those people is post-settlement. By definition, that is something that insurers are not in a position to know, because once they have made the final payment they do not know how that money is invested and do not have a view about whether it has lasted over a 10, 15 or 20-year period. It is a shame that that evidence has not been provided to this inquiry.

There are some indicators that the rate that was set earlier this year is likely to lead to overcompensation. The first is the Government Actuary's report, which is done by independent Government actuaries using useful and well-proven methodology. That came up with a 96% probability that the current rate will lead to overcompensation—not what Parliament intended.

Secondly, the British Institute of International and Comparative Law looked at the discount rate for the UK versus 26 other common law jurisdictions and found that the new rate puts the UK at the lowest of the 27, whereas before it had been roughly in the middle. Both those independent areas point to a new rate that is likely to lead to overcompensation, and therefore not what Parliament intended. We would be as happy as anyone if there were more evidence provided about the actual financial position of claimants 10, 15 or 20 years down the line. That evidence has simply not been provided to this inquiry.

Q44 **Chair:** Mr Johnson, what is your take on that?

David Johnson: I would echo all of that. PPOs, which were addressed earlier on, are a route out for a claimant who is concerned about whether they can invest their damages to achieve the rate of return they need. If they opt for a PPO, they get paid an annual amount that is linked to ASHE, as was mentioned, and so is linked to the increase in care costs.

The uptake of PPOs is very low. If it was truly the case that, even under the 2.5% previous discount rate, claimants were left unable to meet their needs, the uptake of PPOs would be higher. The excuse is given about its not applying in Scotland. That does not address the lack of uptake in England and Wales. The indemnity premium point is a very rare occurrence. When it comes to claimants not being offered PPOs, they can always make an offer of a PPO. It is not the case that only defendants

make offers in settlements of claims. PPO offers can be extended by claimants, but they rarely are.

Q45 **Chair:** At what level are insurers reserving for PPOs at the moment? Can any of you help me?

Huw Evans: The previous indication given was correct. It is at the 1% to 2% mark. Insurers are disappointed and surprised that the level of periodic payment orders has declined from 2012, when it was at a peak. Our indications are that it is about 10% take-up at the moment. That is too low. For catastrophically injured people who have zero appetite for risk, to whom the previous panel referred, a periodic payment order is the correct option. Insurers will not decline a PPO in that circumstance. Even if they did, the courts would not allow them to. That is the system that Parliament has put in place, and it works.

The problem is a much more deep-seated and attitudinal problem among claimants, who seem very unwilling to take PPOs. I suspect that there is a variety of reasons for that, but it is not down to insurer reluctance. The courts exist to ensure that, even if there were any residual reluctance, PPOs can be put in place, particularly for those who are most vulnerable. We have a much more deep-seated problem around the reluctance to take what will guarantee you for life that your bills will be paid. I would like to see far more people take them up as a way to provide them with peace of mind, which I think we can all understand is an important component for people in that position.

David Johnson: There is an obligation on a judge to make a decision as to what the appropriate form of compensation is—PPO or lump sum—and ultimately it is not for the parties to dictate to a judge. The judge makes that decision. The fact that judges are not making PPO orders in every case, but are quite happy to impose lump sums will give you a window as to what the attitude of the courts is as to whether there is undercompensation or not.

Q46 **Chair:** Ms Hallinan, can we get your take on it?

Emma Hallinan: As a not for profit defence organisation offering discretionary cover, we are not deemed to be automatically secure to give PPOs, but we have in the past had a mechanism for offering PPOs to claimants. We found that the uptake for PPOs was minimal, and we decided, as of last year, to revert simply to offering lump sums. Our experience was that claimants preferred lump sum offers.

Q47 **Mrs Badenoch:** I have a very brief question. I did not know that there was reluctance among claimants to take the PPO option. Can you give the reasons why that is the case? What exactly are the reservations that people have, because it does sound like a better option in most cases?

David Johnson: There are some human nature aspects. A PPO arrangement involves the insurer making payments on a year-on-year basis for the duration of the loss, which often with catastrophically

injured claimants is the duration of their life. It is sometimes the case that people want closure. They do not want an ongoing relationship with insurers, so they opt for the lump sum rather than the PPO. Certainly an inference to be drawn is that they do not feel the need to opt for a PPO because they feel that they can take a lump sum, make investments and cover their losses; and that what you are being told about undercompensation is simply not the case, and the lump sum is viewed as a perfectly viable option for them.

Q48 **Mrs Badenoch:** It isn't anything to do with difficulties in administration or other knock-on effects from an ongoing relationship, or anything like that?

Huw Evans: The law changed in 2005 to make it mandatory effectively for insurers to offer a PPO if a defendant wanted one. That is the right thing to do. I do not think those barriers are in place any more.

There are two other areas that are potentially part of the mix, although it is impossible to measure. The first is that these are people who have obviously suffered a catastrophic injury, and for some of them there is a behavioural desire to have control over something, rather than to feel that they are just the recipient of an ongoing payment, even if being a recipient offers a degree of security. They want to feel that they can control their destiny by having some control over the lump sum, obviously working with an adviser to manage that investment.

Secondly, for some who may be concerned about their life expectancy, if they take a lump sum, they may, depending on what happens to them, be in a position to leave some of that lump sum to dependants. People feel very strongly about that, given the loss of earnings for their lifetime. With a PPO, there is nothing to leave to a dependant because the guarantee is that it is there for as long as the claimant lives. Those are probably the reasons that go through claimants' minds in the terrible circumstances in which they find themselves.

Q49 **Chair:** I want to clarify one thing. We were talking about how much insurers are reserving on PPOs, and the previous panel's evidence suggested it was a negative figure of -1.52. Is that right?

Huw Evans: Yes. Insurers, particularly general insurers who do not have a business model set up to manage 30-year or 40-year liabilities—that is much more the business model of a pensions company—are required by the regulator to reserve very cautiously, to ensure that they have the funds to pay out over what can be a very uncertain mortality perspective for a claimant. The regulators have paid very close attention to that in recent years.

David Johnson: To address your point on administration directly, PPOs are governed by a court order. There are very prescribed formulae and timetables within that court order. There is imposition of interest if there is ever a late payment. Of course, if the defendant does not adhere to the

terms of the court order about payment, the claimant can always have recourse to the court, but that rarely happens.

Q50 **Bambos Charalambous:** On the PPO point, if you have had life-changing injuries, you may need a lump sum to make alterations or to have adaptations to your home. That may be another reason why PPOs are often not accepted. Is there any scope for having part lump sum and part PPO?

David Johnson: The reality is that in every case when a PPO is made it is alongside a lump sum. The general approach is that future costs around care and appointing a court deputy are dealt with by PPO, but the other aspects of the claim are dealt with by lump sum. You would generally see an order that prescribes £X million as a lump sum and then an annual payment of £X hundred thousand thereafter.

Q51 **Alex Chalk:** Are you saying that, if an insurance company has to budget for paying out sum X over a period of 20 or 30 years, its own internal discount rate, which it would apply, would be about -1.5%? Is that what you are saying?

Huw Evans: They will vary somewhat, but they certainly apply that discount rate to how they reserve.

Q52 **Alex Chalk:** Presumably the counter-argument would be put that you have a greater appetite for risk and you can afford to do it, whereas an individual might not be in a position to allocate such a discount. What would you say to that?

Huw Evans: It comes back to the wider question about evidence of what individuals actually do with their investments. Clearly, that is what the insurance system is for. As I say, it is an important part of the system, and we would like to see more people making greater use of PPOs. The regulator requires insurers to reserve very cautiously, to ensure that they can never be in a position where they do not pay out. You should look at that as being as much a reflection of what the regulator requires of an insurer as any objective view on what future discount rate the Lord Chancellor might set.

Q53 **David Hanson:** There have been arguments put to us—indeed, the Government put them in the consultation—that the present law protects the most vulnerable clients. Why would you want to change that system?

Huw Evans: The area of the current system that most protects vulnerable clients is the existence of the PPO, because it ensures that they can never run out of money. That would obviously remain intact. It is a very good argument that if you stuck with the current system, as set from March this year, you would not protect anyone meaningfully, because the settlement system would remain gummed up by very vexatious disputes between the two sides. It has already slowed down a lot. This is not a system that has worked terribly well in recent years. As previous witnesses pointed out, there has been reluctance to review it.

The MOJ has consulted on three separate occasions over the last seven years about the system, so there has been a lot of debate and discussion about how to do it.

We need a reformed system that keeps the principle that Parliament identified 21 years ago about 100% compensation and uses a modern methodology to calculate it. It should be based around how claimants actually invest their money. It should preserve the existence of PPOs for the most vulnerable and should be regularly reviewed on a three or five-year basis. That would effectively combine the best of both the old system and the new system. The problem that has arisen with the current system is the lack of any form of review. Having a three or five-year review period will make a big difference, but based on a modern formula so that the system is not as unstable as it has been in recent years.

Q54 **David Hanson:** Is there a financial benefit to your members from the proposed changes?

Huw Evans: Yes.

Q55 **David Hanson:** How much?

Huw Evans: It is impossible to know really because the new system has only just come in. There is certainly a significant cost to the insurance industry—

Q56 **David Hanson:** Just help us out, because obviously we are looking at this in pre-legislative scrutiny and one of the changes is potentially that vulnerable clients could be disadvantaged and insurance companies could be better off. I am sure you have made an assessment of how much the insurance companies would benefit if the proposals went ahead as planned.

Huw Evans: I would like to answer that. At the moment, insurance companies, as they testified in their evidence to you, have not passed on the full -0.75% discount rate to customers. That is because the Government promised to review it and put in place the process that you are engaged in at the moment at the same time as announcing that. The companies took the view that they would not pass that rate on to customers in full. They passed on some of it. Therefore, future savings that may or may not accrue are likely to be more modest than if they had just passed on the full lot, and it was then reversed.

What will definitely happen if the system is not reformed is a significant increase in cost to insurers, which will end up ultimately being borne by customers, particularly by younger and older drivers who are the most likely risk group who cause these sorts of accidents in the first place. You cannot change the discount rate so fundamentally without increasing the cost of insurance for customers who pay for it.

Q57 **David Hanson:** Are you telling the Committee that you have made no

estimate that you can give us about how much overall insurance companies would recoup and save as a result of the proposals?

Huw Evans: We do not know what the rate is going to be.

Q58 **David Hanson:** But you are in the business of assessing risk and its management. Presumably you will have taken a view, when the legislation comes before the House, that, if it is X rate or Y rate, there will be a change in the saving to the company; otherwise what would you be lobbying us on?

Huw Evans: We are lobbying you on both the principle and the practice of the market. The principle is the way it should work and the practice is how to ensure that the maximum number of people, including younger drivers, can buy insurance at prices they can afford, with a system that actually works, compensating claimants fairly, neither under nor overcompensating them. That is why we want to see the changes.

To answer your question on the numbers, we have not done the calculations, but Willis Towers Watson, an independent consultancy, has estimated—it is an estimate—that, if the current number of -0.05% stayed in place, the cost to the insurance sector, and therefore to customers, would be in the region of £700 million a year. Until we know what the actual new rate would be set at, it is impossible to say how much of that would not be passed on.

Q59 **David Hanson:** Can I help you? The Government said that the rate is going to be between 0% and 1%, so presumably somebody in your organisation has made an assessment of how much the insurance companies would benefit if the rate was set within that framework.

Huw Evans: If you take -0.75% and the Willis Towers Watson number as being £700 million, and then you end up with somewhere halfway between them, it will be half that number. But we have not made those calculations because our job, representing the insurance industry, is not to produce guesswork, either in this forum or putting it into the market, that would cause market dislocation. We do not do that. We have not put that number forward, either in attempting to lobby for our position or otherwise.

We have been very honest. There would be some savings to customers if this reform were put through, but the reason that parliamentarians should agree these reforms is not to deliver some massive savings to customers, but to have a healthier system that helps to prevent much bigger cost increases if the system stays unreformed.

Q60 **David Hanson:** Could you help me by confirming how much average motor premiums have increased over the last three years?

Huw Evans: They have gone up on average by £100.

Q61 **David Hanson:** In percentage terms that is about 8%, roughly. That is the figure we have.

Huw Evans: A bit more than that, I think, but they have certainly increased.

Q62 **David Hanson:** Has the number of insurers settling PI claims fallen?

Huw Evans: No. I think the run rate of insurers settling claims, until the discount rate was revised in March, has been stable.

Q63 **David Hanson:** We have a 13% figure for falls in claims in the last three years.

Huw Evans: But a fall in claims does not mean a fall in settlements. There has been a fall in the number of claims, in part because of previous reforms that Government and Parliament passed around whiplash. There has not been a fall in the type of catastrophic claims that we are discussing here.

Q64 **David Hanson:** The bottom line for the Committee would be a commitment from you on whatever that figure ends up being in terms of savings for the insurance companies. Is that going to go to the insurance companies or is it going to go back in reduced premiums?

Huw Evans: I am very happy to point to the statements that have been made by leading insurers that any savings that result—albeit that I caution they would be modest; I want to be honest about that—would be passed on to customers. You have seen that in the past. When Parliament passed the LASPO Act in 2013, there was a £1 billion reduction in the cost of motor premiums, down to the point that you have just referred to, as a result of the savings that were made on legal costs. We are not asking you to accept a hypothetical. This is something that has happened in the past. When cost is taken out of the system, in a highly competitive market, those costs are then passed on in reduced premiums to customers. But I would caution you—

Chair: I think you have made the point a number of times.

Q65 **David Hanson:** I have a final question. How would we hold you to account on that? How could we have information that the overall cost and saving to you is X, and that you have passed on Y to the consumer in due course?

Huw Evans: The ABI publishes the motor tracker that you have just been quoting. We publish data about how much customers actually pay in motor insurance premiums, for example. We publish that every quarter. It is freely available. You will have our data to see what is driving motor premiums. There are other impacts, of course; insurance premium tax, exchange rates and the cost of repairs all have an impact on the price of motor insurance. None the less, you will have our data. Clearly under the framework that is proposed, there will be a regular review of the discount rate, and if the Government feel misled by the insurance industry at any point, I am sure the Lord Chancellor will take it into account in any future decisions they take.

Q66 **Chair:** Ms Hallinan, I would like to get your aspect from the Medical Protection Society.

Emma Hallinan: In relation to?

Chair: The potential impacts; what the impacts are in the current situation and what the changes might do, given that you are essentially a not for profit organisation which acts on behalf of the medical profession.

Emma Hallinan: Our membership includes general practitioners, dentists and doctors working in the private sector. The discount rate would have an impact on cases involving long-term future loss. In terms of our obligations as a mutual not for profit organisation, we need to ensure that we collect enough subscriptions from members to meet the expected future costs of claims and to ensure that we are able to defend their interests long term in the future. If the discount rate methodology changed, it could have an impact on subscription rates, but we would have to weigh that with other factors—for example, the severity of average claims and the frequency of claims.

Q67 **Chair:** What is your broad stance on the Government's current proposals?

Emma Hallinan: We would be very supportive of the Government's proposals. We are also mindful of the fact that the Government recognised that the discount rate change would have an impact in terms of NHS liabilities and general practice liabilities. The Government were looking at mitigating that impact, so for the time being we have not passed the cost of the discount rate on to our general practitioners, while we work with the Department of Health to see how that mitigation might work in practice.

Q68 **Chair:** Mr Johnson, do you have any thoughts on impact?

David Johnson: Going back to Mr Hanson's line of questioning, when looking at this new legislation and a change in the way the discount rate is arrived at, it is wholly wrong to think that we are choosing between protecting vulnerable claimants and abandoning them. I totally refute what was said earlier on—that you are being asked to take a risk premium paid to a claimant and give it to insurers.

Q69 **David Hanson:** It was a point put to us, and it was in the Government consultation, so it is not just comment here. I am asking you to comment on comments that have been made.

David Johnson: What everyone is in agreement with is that we are targeting 100% compensation; not undercompensation that would leave people in difficulty or overcompensation, which goes to your line of questioning about the cost to society and the cost of the increase in premiums, and what have you. We are not talking about paying the risk premium for claimants back to insurers. We are talking about getting that risk premium right. The current discount rate of -0.75% is not the right

rate. As the Government Actuary's Department report reflects, it appears to be overcompensating, and we have not seen any evidence today about the suggestion of undercompensation. What the new proposed legislation is about is getting the formula for measuring the discount rate right and achieving the right outcome.

Q70 **Chair:** Is the market world the same in your experience as it was at the time of the decision in Wells *v.* Wells? That case was in 1998. How much has changed around the landscape of investment?

Huw Evans: The biggest change, if I can answer that, is that ILGS is now trading at a negative. When the Wells *v.* Wells judgment was given in 1998, there was a perfectly respectable argument for using index-linked gilt securities as a proxy for a very low risk or non-risk investor. They traded at a positive rate and they protected against inflation, which, at the time, was a much bigger threat to people's incomes.

The biggest difference now is that because of the financial crisis and the relative scarcity of those gilts—they are not available as much as they were—the prices are much higher and the supply is much lower. They have traded consistently at a negative since the first half of 2014. That is the biggest difference, which is why it makes it almost unbelievable to suggest that people who are in some of the most vulnerable positions should invest their lump sum in an instrument that is going to lose them money from day one. That would be crackers financial advice, and anyone should sue their adviser for giving it. It is even more bizarre to propose carrying on basing the law around that system.

Q71 **Chair:** That is your assessment on the market trend. Is there anything from the legal aspect, Mr Johnson, in terms of whether or not the mechanism that Wells *v.* Wells suggested—the gilts—is now relevant, in your experience as president of a body of practitioners?

David Johnson: The 100% principle in Wells *v.* Wells still stands.

Q72 **Chair:** Everybody seems to be agreed on that.

David Johnson: Yes. All I can really point to is that the current outcome of -0.75% appears somewhat perverse. I think that underscores that times have changed, and that it is no longer appropriate to link discount rate to ILGS. I am not sure you could invest your fund fully in ILGS, even if you wanted to, and you would be very ill advised to do so.

Huw Evans: Of course, it was the case, when the Lord Chancellor, as far back as 2001, set the rate, that the courts told the then Lord Chancellor that they felt that claimants even then were not using ILGS. That is when they were trading at a positive rate. As far back as 2001, there is evidence from the courts, not from insurers or anyone with a stake in this, that real claimants were not using ILGS; they were using a mixed basket of instruments. Of course, with the move in the markets in the last three years, that is a no-brainer.

Emma Hallinan: I agree with Mr Johnson and Mr Evans in that respect.

Q73 **Laura Pidcock:** Do any of you think there should be a more precise definition of the assumed level of investment risk than in the current draft?

David Johnson: The current system tied the previous Lord Chancellor to ILGS. The contrast we have just talked about, between the position when that was set, back in 2001, and where we are now, highlights the problem that arises if you tie the Lord Chancellor's hands too narrowly. If you keep a degree of flexibility, that allows—

Q74 **Laura Pidcock:** What kind of flexibility?

David Johnson: The current legislation allows him or her to take advice from an expert panel and does not channel them down one route, such as ILGS. If the performance of investment portfolios changes in the future, the Lord Chancellor will have room to reflect that in his decision. At the moment, we have arrived at a very unsatisfactory rate, which, according to the Government Actuary's Department report, overcompensates. That is a product of too narrow an approach and not allowing the Lord Chancellor that degree of flexibility.

Huw Evans: It would be a healthier system if there were a panel of experts, some of whom were involved in advising clients, whose day job was to measure the different calibrations of what low risk can involve and who had a good feel for the market, who were able to advise the Lord Chancellor. I still think that in a democracy a Lord Chancellor—an elected politician—should take such a fundamental decision, but on a well-advised basis.

The other guarantee that goes into the framework is the three-year review period. If there is a meaningful change in the market that looks like it would be sustained, that would allow the assumptions around the portfolio to be revisited. Where the previous system went wrong was that when we had the financial crisis, with the introduction of quantitative easing and all the knock-on effects of that, there was not an automatic review mechanism that kicked in, and that led to the problems with the previous rate. The combination of an expert panel, whose hands are not tied too much, with a regular review, should, hopefully, give the Lord Chancellor the right advice.

Q75 **Alex Chalk:** You said that, because of the seriousness of this, there should be some democratic accountability. Surely if the Bank of England can have independence on something as fundamental as interest rates, it can safely be removed from the hands of politicians.

Huw Evans: You pays your money and you takes your choice on the argument about whether public policy is best done by elected politicians or unelected experts. It is worth noting that, even in the Bank of England case, its decisions and the monetary policy decisions on quantitative easing have had a very profound effect on the economy, on

intergenerational fairness and on the ability of many people with savings products actually to use them. There are profound policy consequences that follow from some of these decisions. I personally, and I think our members, would be more comfortable if the decision was in the hands of an elected politician, but on a regular review basis, so that the politician cannot just kick it into touch, and not touch it, as may have happened under the system that worked up to now. There is no perfect system, but I tend to think that would work better. Ultimately, that politician is then accountable to Parliament for the implementation of the law that you have passed.

Q76 **Laura Pidcock:** Do you agree or disagree with that, Ms Hallinan?

Emma Hallinan: Yes, absolutely; we would very much see merit in an elected official having the decision-making process for the discount rate in their hands. We welcome the proposal that the working party is made up of a wide range of professions, covering accountancy, actuarial advice and consumer investment advice. We think they would be in a good position to give the Lord Chancellor a steer in relation to the right discount rate, which is fair to claimants. Also, the Lord Chancellor would then be in a good position to look at the wider picture in terms of the impact it could have on, for example, the NHS or other critical public services. We would support that.

Q77 **Laura Pidcock:** What proportion of a low risk portfolio could be equities?

Huw Evans: It varies. The portfolio A that the Government Actuary used in their modelling had it at 28%. Portfolio B had it much higher at 57%. Those are both low risk portfolios, but portfolio B was a slightly higher risk within the low risk category. It was at the top of the low risk category, and portfolio A was nearer the bottom. There is room for assessment, and it would partly depend on a view of the market. It would have to have some equity in there to deliver the return that would be required.

It is really important to remember that we are not talking about short-term investments. We are talking about investments that may last up to 50 years. Over that longer-term period, equities are very likely to deliver stable returns and to be a lower risk choice for any investor, whether they are somebody with a stocks and shares ISA or a claimant in this position. I am sure that the expert advisers who would be advising the Lord Chancellor under that framework would see a decent equity component as part of any lower risk portfolio, but they should always take that judgment on the basis of their view of market stability overall, bearing in mind that it is about a longer-term investment and not a short-term one.

Q78 **Ruth Cadbury:** Ms Hallinan, I am going to go back to something we have just touched on. In your written evidence, you stated that there may be circumstances where it will be appropriate that the Lord Chancellor should not follow the advice of the panel. What circumstances

would those be?

Emma Hallinan: Our view would be that the Lord Chancellor would very much bear in mind the advice of the panel in making a decision about the discount rate, but there could be circumstances where the impact could be so great—for example, on the cost of clinical negligence to the NHS—that they might want to temper that advice in some way.

Q79 **Ruth Cadbury:** If there is a worry about the cost to the NHS from the claim, if somebody who is profoundly disabled is not getting enough from the claim to provide for their basic needs, they are going to get it from the care system. The state is going to have to pay somehow.

Emma Hallinan: Yes. The circumstances in which the Lord Chancellor would choose not to follow the advice of the working panel would be limited, and very nuanced, I suspect, but it is right that the Lord Chancellor is in a position to weigh the impact of any big discount rate change against the societal cost.

Q80 **Ruth Cadbury:** Do you think that the discount rate should be reviewed more or less frequently than the three years proposed in the legislation?

Emma Hallinan: In our response to the consultation, we suggested that it should be reviewed annually, because we thought that would potentially smooth over the impacts of large swings in the discount rate, such as we saw earlier this year. We can certainly see good sense in a discount rate review every three years, and we would support that proposal.

Q81 **Ruth Cadbury:** Do you have any other suggestions about changing the proposed legislation, if you could?

Emma Hallinan: No, we are broadly supportive of the legislation.

Q82 **Chair:** Mr Johnson, do you have any views as to the legislation more generally?

David Johnson: Looking at clause 1(6), we would like the review process to end specifically with an announcement of what the new rate is. It is pretty implicit in the legislation, but we would like that just for practicality's sake, apart from anything else. There is a reference there to "no discount rate." I think that would be better described as a 0% discount rate.

Going briefly to the point about dual discount rates, the legislation currently refers to classes of cases. What was talked about earlier was not classes of different cases, such as motor, employer liability or whatever; you were talking about duration or period of damages—short-term or longer-term damages. Classes of cases is probably the wrong terminology. We need to talk about losses of different duration.

Q83 **Chair:** I understand. Perhaps Mr Evans can help us on a very technical point. Just to clarify, it was around portfolio A versus portfolio B and so

on. As I recall it, portfolio A includes alternatives at about 18%. That brings you down to the 28% figure that was counted. I am advised that actuarial practice will be to count alternatives as equities, and it will therefore be 46%. Is that right?

Huw Evans: I think that is where there is a difference between an actuarial, somewhat purist, view of the world and the way in which financial advisers actually operate and advise clients, including anyone who has an ISA. The way the Government Actuary's Department has classified it is correct in terms of the way the man or woman on the street would see it, and would see their own ISA broken down.

Q84 **Chair:** In terms reflecting investment practice.

Huw Evans: And the different categories. Investing in a hedge fund is not the same as investing in a tracker fund that tracks the FTSE 350. Those are two different types of class of investment. Most investment professionals would separate them. I think the Government Actuary's Department was wise to follow the practice of an investment professional rather than a slightly more purist actuarial view of the world.

Chair: Are there any other points anybody wants to raise with us? We have read your written evidence, for which we are very grateful. Thank you very much for your time and for your evidence to us this morning.

Examination of witness

Witness: Lord Keen of Elie QC.

Q85 **Chair:** Lord Keen, good morning and welcome. I think this is the first time we have had the pleasure of your giving evidence to us at the Committee. We are delighted to see you. You know some of us in any event.

I want to touch on some of the issues as far as this area of Government policy is concerned. I know that you deal with this in your ministerial responsibilities in the Department. It was 16 years before the discount rate was changed. Looking back, do you think that was a mistake?

Lord Keen: I have only been in government since 2015.

Chair: You have an alibi.

Lord Keen: Therefore, I cannot comment on what occurred prior to then, although I am aware that a consultation was initiated in 2010 and followed up some years later. I certainly think, with the benefit of hindsight, that leaving the discount rate in one position for that period of time is not something we would wish to repeat, which is why we propose that it should be reviewed every three years.

Q86 **Chair:** What is the principal objective of the Government's proposals, as far as you are concerned?

Lord Keen: Essentially, to ensure fair compensation for the victims of injury, but also to reflect the rights and interests of those who have to meet those claims for compensation.

Q87 **Chair:** The concept of fair compensation, defined over the years since the House of Lords judgment in Wells *v.* Wells, is that it puts you in exactly the same place, as far as you can be, in money terms—neither more nor less. Do the Government remain committed to that?

Lord Keen: In so far as that can be achieved. We appreciate that this is not an exact science. It invariably involves judgment at a number of levels.

Q88 **Chair:** We have heard some evidence that claimants were undercompensated for quite a period, before the rate was reduced to the current -0.75%. Is that the sense that the Government have? In retrospect, do you think that is another argument for adjusting more frequently?

Lord Keen: I certainly believe that there is a need to address the discount rate at sensible intervals. I do not think we are impressed with the idea that 15 years is a sensible interval. Three years is a far more appropriate timescale for that purpose.

Q89 **Chair:** You make the point—consistent with evidence we have heard from a lot of people—that it is not an exact science, and that there is an element of judgment. You used the phrase "to protect as far as you can." I suppose the point might be made that, if there has to be any risk of error either way, should that not fall in favour, almost as a matter of public policy, of overcompensation because the state or the insurer is better placed to bear the risk than the individual or a smaller group?

Lord Keen: I do not believe that it is a case of judging risk. There are issues about compensation that involve matters of judgment. To take the classic example, no matter where your discount rate is placed, longevity plays a real part in the determination of whether or not a person has been overcompensated or undercompensated. At the end of the day, the court has to make a judgment, and in the context of fixing the discount rate the Lord Chancellor will have to make a judgment that balances the interests of claimants and defendants.

I would add this, if I may. No matter where you place the discount rate, it is clear that there is always the potential for some victims to be undercompensated, just as there is the potential for many victims to be overcompensated. To take the example of the current -0.75% discount rate, it is anticipated that the median victim—if I can put it in those terms—will be overcompensated to the extent of 135%, or perhaps lower, to 120%, if you take account of management charges. At the same time, there is at least a 4% probability of victims being undercompensated by more than 5%. That is why it is not a science. It is a somewhat uncertain area, in which judgment prevails.

Q90 **Chair:** The consultation paper that the Department issued spoke about the present law protecting the most vulnerable claimants. How do you make sure that the changes achieve that objective and meet things like the public sector equality duty and so on? How do you think you will manage that in that balance?

Lord Keen: Going forward, the Lord Chancellor will, of course, be guided by an expert panel who will have input. There will be an economist; there will be an investment manager; and there will be somebody concerned with the consumer aspects of financial investment. He will be guided as to what is, in his judgment, a proper determination of the discount rate, taking account of the fact that there may be circumstances where some will be undercompensated and many will be overcompensated. It would be extremely surprising if the Lord Chancellor found himself fixing a discount rate in which many were undercompensated and a few were overcompensated. I simply do not believe that in the exercise of proper judgment that result would prevail.

If there was some material change of circumstances that impacted upon the discount rate, the Lord Chancellor would not have to wait for the triennial review. He could take steps as and when such an event occurred.

Q91 **Ellie Reeves:** My understanding is that the idea of claimants being overcompensated comes from a Government Actuary report. The portfolios in that report are based on unpublished questionnaires returned by only four wealth management firms. Is that the total evidence for the idea that claimants are being overcompensated?

Lord Keen: It is not the totality of the evidence. We have had submissions from both claimants and defendants about the issue of the discount rate and its impact upon the level of compensation that is received. We have the perceptions, for example, of insurers as well.

Can I be clear? The Government Actuary's Department findings were an illustrative review, essentially, based on the material that was placed before them. As you know, there were two portfolios of investment that were analysed by the Government Actuary: portfolio A and portfolio B. While portfolio B might have reflected the conduct of claimants in the past, because of the relatively high discount rate, portfolio A was wholly independent of that, and therefore was reflective of what would actually happen in the market when a claimant was investing their fund.

It was interesting when we spoke to those involved in the investment of funds on behalf of claimants that they talked about the investment classes selected by portfolio A as reflecting low risk, defensive, cautious, personal injury, and low risk overall. Indeed, it was the sort of investment they would make for someone subject to the Court of Protection, for example. There was a clear body of evidence pointing to the way in which the funds could be invested. Over and above that, there

was the Government Actuary's determination that the median was being overcompensated to the extent of 135%.

Q92 **Ellie Reeves:** But would it not be better to have a broader approach to who is sampled? Your own published research from 2013 indicated that claimants were risk averse, but that a more purposive sample would capture what vulnerable claimants were actually doing financially. Those four wealth management firms would not capture that information in their evidence from vulnerable claimants, would they?

Lord Keen: What was captured was the fact that vulnerable claimants do not invest entirely in index-linked gilts, which is what is perceived to be the very low risk regime reflected by the decision of the House of Lords in Wells *v.* Wells. That simply does not happen. They go into what is described as a low risk portfolio. Of course, they are risk averse, but nevertheless there is no compelling evidence that vulnerable claimants are investing purely in index-linked gilts up to the period of redemption, for example.

Q93 **Ellie Reeves:** What do you think of the proposal that the legislation should require professional deputies acting for claimants to file anonymised annual returns that show what claimants have actually been doing, and where they have been investing, to get a broader perspective about what is happening among vulnerable claimants?

Lord Keen: In due course the Lord Chancellor, when he comes to fix the rate, will be able to look at a wide body of evidence, as will the expert panel. If that sort of material is submitted, it will clearly be available for consideration.

Q94 **Ellie Reeves:** We have heard a lot about the idea that reducing the discount rate will tackle rising clinical negligence costs. The NAO did not even mention discount rates in their analysis of what is driving costs upwards. Is that argument just nonsense?

Lord Keen: I would never describe an argument as nonsense, but what I would say is this. The proposition is misplaced. This is not about reducing the cost of clinical negligence claims. This is about ensuring fair and reasonable compensation for those who become the victims of clinical negligence.

Q95 **Victoria Prentis:** While the discount rate has been high, claimants have been forced to invest in higher-risk investments than we might traditionally think is the sort of thing claimants use. How can that be fair?

Lord Keen: In the past, there must have been some pressure for claimants to invest in what would be regarded as more than very low risk portfolios in order to ensure, on the basis of the professional advice received, that they could meet their needs going forward. I accept that, and that is why the whole picture required to be reviewed. There is no question of that whatsoever.

I would, however, add that this is not, if I can term it, a monoculture. There are certain alternatives—for example, PPOs. The Committee will have heard already that it is possible in particular cases, and certainly in cases of catastrophic injury, for periodic payment orders to be made in order to address the potential difficulties that may arise with a particular form of investment portfolio, but even that, I accept, is not faultless.

Q96 **Victoria Prentis:** Is that something the Government are keen to promote, not least because the cost of care is rising and, happily, people live longer than is currently expected. Are PPOs the way forward?

Lord Keen: I certainly see evidence, for example from the national health service, that in the case of what might be regarded as a small percentage of claims—it is a small percentage—PPOs are generally sought and agreed. While they represent only a small percentage of claims, they represent by far the greatest part of the value of claims dealt with by the health service. In other words, it is in the catastrophic injury cases, particularly of children for example, that you find PPOs being ordered.

There is mixed evidence about PPOs. There is some evidence that claimants are not particularly enthusiastic about them. There is some evidence that insurers are not always particularly enthusiastic about them, because of the regulatory regime that impacts on their capital requirements going forward, but, generally speaking, they are utilised in cases of catastrophic injury, where they are most needed. We certainly consider that that is appropriate.

Q97 **Victoria Prentis:** In the schedule, the assumption is made that the discount rate is set on the basis that claimants will be well advised. Given that that is the case, should not the cost of getting proper advice be part of the claim, as the Law Society suggests?

Lord Keen: I am aware of the Law Society proposal. At the present time, under our law it is not possible to identify a distinct and separate head of damage based on professional advice. In fixing the discount rate, the Lord Chancellor will have regard to the fact that any investment portfolio will be the subject of management charges, and that will be reflected in the determination of the discount rate. There is some evidence of that disclosed in the report from the Government Actuary, where he talks about the shift in the median overcompensation, depending on whether or not you apply an element for management charges.

Q98 **Victoria Prentis:** The impact assessment does not quantify the costs and benefits of the proposed legislation on the grounds that the rate will not actually change until after the Lord Chancellor's review, but you estimate that the rate likely to result will be between 0% and 1%. Why didn't the Government calculate the costs and benefits based on that estimate?

Lord Keen: I think one has to be careful. The figure of 0% to 1% that was given in the paper was not an estimate, essentially, of what the Lord Chancellor would be fixing as the discount rate. It was an assessment of

the direction of travel of the rate, in the event that we moved from a very low risk portfolio to a low risk portfolio. It is based on figures in the Government Actuary's report that indicate a growth rate of about 1.3% during the first 30 years of an investment portfolio, moving up to 1.6% and then taking that back by about 0.5% to allow for management charges and tax. That is how the 0% to 1% figure was arrived at, but I emphasise that it was not intended as an estimate of what the rate will be. With the benefit of hindsight, it is perhaps unfortunate that the figure was there, but it was just to indicate the direction of travel when you moved the risk element of the portfolio.

Q99 **Victoria Prentis:** That is very helpful. Does the Department have any evidence that insurance companies will actually reduce premiums as a result of this proposal?

Lord Keen: Certainly one of the major motor insurers, LV, has already publicly stated that they will reflect the savings in premium savings. It is important to notice that a very large proportion of these claims arise as motor insurance claims, and it is a very competitive market. If one of the leaders in that market is going to pass on those savings, it would be surprising if others did not feel obliged to do the same.

Q100 **Victoria Prentis:** But the Department has done no analysis of that.

Lord Keen: We are relying on what has been said in the public domain by some of the principal insurers.

Q101 **Chair:** There was one quite technical point that was raised with us about the definition of low risk. Lord Keen, you have already mentioned the sliding scale. One proposal that has been put forward was that the Government should seek to define that more precisely—for example, by means of measurement by the observed standard deviation of a portfolio of investments and perhaps limited to a standard form of deviation. Is that something that is attractive to the Government?

Lord Keen: I do not believe it would be. I am not sure it would be attractive for many of those involved in this area. When you go out to those involved in investment portfolios, you find that terms such as low risk and very low risk are deployed. Nevertheless, they do not have a fixed definition, and that is why it is useful to tease out from those who are expert in the area what they mean by low risk. They talk about a cautious investment strategy. They talk about a defensive strategy. They talk about a personal injury portfolio. They talk about a conservative approach to investment. Those expressions help to embody what we are attempting to achieve, but to have fixed parameters or definitions would prove potentially unhelpful going forward.

Q102 **Chair:** Some respondents to the consultation were suggesting a higher level of risk than the Government have in fact settled on.

Lord Keen: There are those who would have suggested that it should move towards the level of risk reflected in portfolio B in the Government

Actuary's report. We have to look at the range of consequences for various rates, and taking it up to that level, in the view of the Government, would reflect too high a degree of risk for claimants going forward.

Q103 **Bambos Charalambous:** On the issue of process, would not the continued use of ILGS avoid, as the Institute of Actuaries put it, the accusation of political bias towards claimants or defendants?

Lord Keen: I am sorry; I do not understand the question.

Q104 **Bambos Charalambous:** If you carried on using the ILGS, wouldn't that avoid the accusation of political bias?

Lord Keen: I think the problem is that ILGS is not used. We do not have a situation in which, generally speaking, claimants put their entire award into index-linked gilts. That just does not happen, so it does not present a realistic picture of what is happening. I am sorry, I did not pick up the reference to ILGS.

Q105 **Bambos Charalambous:** The proposal is that the Government Actuary chairs the expert panel and has the casting vote. Doesn't that mean that people will say that the Government have a vested interest in keeping clinical negligence costs as low as possible?

Lord Keen: Absolutely not. The Government Actuary is an independent person. Clearly, someone must have a casting vote in that context, before the Lord Chancellor receives the advice. I would suggest that there is no one better in that context.

Q106 **Bambos Charalambous:** Would there be any instances in which you think the Lord Chancellor could ignore the advice of the expert panel?

Lord Keen: The Lord Chancellor could not ignore the advice of the expert panel. The Lord Chancellor will always take account of the advice of the expert panel, but it is advice, and he then has to make what is essentially a political judgment about the appropriate level at which to fix the discount rate.

Q107 **Bambos Charalambous:** Would the advice of the expert panel be publicly available?

Lord Keen: It would be a matter in due course for the Lord Chancellor, but certainly our aim is to bring more transparency to the process, particularly in light of the point made by the Chair about there having been a 16-year delay in reviewing the matter. We want to see a great deal more transparency.

Q108 **Bambos Charalambous:** Would it be possible to look at any dissenting views, if people on the panel have conflicting views?

Lord Keen: I cannot anticipate how the Lord Chancellor would approach that issue, but clearly panels of that kind generally seek to produce some

degree of consensus when they are seeking to advise a Minister, even if it involves an element of compromise at times.

Q109 **Chair:** How promptly do you think it will be possible, if the legislative changes are approved, to set the rate for the first time? The proposal uses the word "promptly." There was interest among our respondents about how quickly that will be.

Lord Keen: We certainly hope that the legislation will come into force by the early part of next year, and the Lord Chancellor will set about fixing the discount rate as soon as he can thereafter. We do not anticipate a lengthy window before the discount rate is reviewed for the first time.[1]

Q110 **Chair:** Lord Keen, thank you very much. You have been very comprehensive in your answers to us. Of course, we have a great deal of written evidence to assess for our report. I am grateful to you for elaborating on the issues that we raised with you, and for your time today.

Lord Keen: I am grateful to the Committee for hearing me and for their courtesy. Thank you.

Chair: It was a pleasure. That concludes the formal evidence session. Click here to enter text.

[1] Note by witness: subject to the response to the draft legislation, the Government intends to legislate promptly to make sure that the way the rate is set is put on the best possible footing at the earliest practicable date.