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# When is a discount not a discount?

*HBA Legal reflects on the March 2017 change to the UK discount rate for future loss calculations and what it means for the Australian insurance market.*

## What are the changes?

Future loss calculations in UK personal injury claims are set to skyrocket, with Lord Chancellor Elizabeth Truss announcing an unprecedented cut to discount rates from 2.5% to -0.75% (commencing 20 March 2017),

Discount rates are applied to lump sum future compensation claims to acknowledge the potential for a claimant to earn interest on that sum, with the typical result being that the insurer would pay out less than the loss suffered.

The decision by Truss to lower the discount rates into the negative realm, however, flips that whole concept on its head, meaning that insurers will now pay more than the loss suffered. In short, there is no longer a discounting of rates.

## Driving force behind the changes

The impetus for change in the UK context was the need to ensure a better and fairer framework for personal injury claimants, particularly those with permanent or lifelong injuries: "compensation awards using the rate should put the claimant in the same financial position had they not been injured, including loss of future earnings and care costs."

The ability of compensation awards to do so, however, appears to have been affected by the massive economic upheaval the UK has experienced over the past decade. While the discount rate had previously remained untouched at 2.5% for 16 years, interest rates in the UK have dropped substantially in that time[1] (from 5.75% to 0.25%[2]). Effectively then, the new rate of -0.75% seeks "to ensure inflation does not erode the future value of a damages payout."[3]

Though Australia also saw a drop in interest rates from 2001 to 2017 (5.75% to 1.5%), it was able to avoid recession in the wake of the global financial crisis, and has not experienced a shakeup like 2016's "Brexit" decision.

## The setting of discount rates

UK discount rates have traditionally been determined by reference to Index-Linked Government Gilts.

In Australia, discount rates are prescribed by state governments, meaning there is no uniform rate across the country. Even within state lines the rates can differ depending on the nature of the injury suffered.

For the most part these rates were set in the wake of the public liability insurance crisis that gripped

Australia in the early 2000s. That crisis was the trigger for the Review of the Law of Negligence. In that review (commonly referred to as the “Ipp Report”) it was noted that, stability of discount rates was of paramount importance:

*“In fact, recent history suggests that there is unlikely to be a strong economic case for anything more than small changes in the discount rate over the long term. On this basis, it might be suggested that the costs of change are likely to outweigh the advantages.”*[4]

In New South Wales, for example, discount rates across all claim types were set at 5% in 2002, and have remained unchanged ever since.[5]

## Impact of the changes in the UK

While UK claimants and personal injury lawyers are sure to welcome the reduction, the Association of British Insurers has lambasted the move as “crazy”[6] and “reckless in the extreme”[7].

A chief concern is the fact that a vital service like the NHS (National Health Service) could face an annual bill of £1 billion as a result of the changes.[8] Accordingly, healthcare professionals have proposed reforms to personal injury law to address the problem with the hope that a review of the discount rate reduction will trigger further change that will benefit both sides[9].

Of course, it’s not just insurers who should be worried. The reduction of the discount rate will likely raise British insurance premiums with estimates of up to 36 million individual and business insurance policies being affected[10].

An increase of this nature is likely to see a return to a more adversarial system of litigation where major heads of damage are challenged. If the Australian experience is anything to go by, it may also engender in the UK a need for civil liability legislation and a system of capped damages.

## What would the changes mean if applied in Australia?

As shown below, the impact of moving to a negative discount rate in the Australian context would be severe, especially as most jurisdictions presently employ a 3% or 5% discount for future losses (calculated weekly).

The following table compares a $100 per week loss for a period of 10 years:

| | **Amount** | **Years** | **Multiplier** | **Award** |
|---|---|---|---|---|
| 5% table | $100 | 10 | 412.9 | **$41,290** |
| 3% table | $100 | 10 | 451.8 | **$45,180** |
| No discount | $100 | 10 | 521.4[1] | **$52,140** |
| -0.5% discount | $100 | 10 | 531.8[2] | **$53,180** |

[1] Approximate number of weeks in ten years

[2] Our estimate on the likely weekly multiplier for -0.5% discount, based on a comparison between the 3% and 5% and of the non-discounted figure. This resulted in the following calculation 0.5(%) x 4 = 2(%); 521.4 + 2%.

As can be seen, a move to a discount rate of -0.5% would increase payments by **18%** when a 3% multiplier is used and **29%** on current awards when a 5% multiplier is used.

The following table compares a $100 per week loss over a period of 20 years:

| | Amount | Years | Multiplier | Award |
|---|---|---|---|---|
| 5% table | $100 | 20 | 666.4 | **$66,640** |
| 3% table | $100 | 20 | 787.9 | **$78,790** |
| No discount | $100 | 20 | 1042.9[3] | **$104,290** |
| -0.5% discount | $100 | 20 | 1084.6[4] | **$108,460** |

The impact of any discount rate cuts over a period of 20 years would have a staggering impact on payouts, with a **38%** increase on the current award compared to the 3% tables and a **62%** increase compared to the 5% tables.

## A considered forecast for Australia

Despite no changes for 16 years, the UK's move is timely considering the fallout from the 'Brexit' referendum and the resultant uncertainty. Indeed, this much is apparent from Lord Chancellor Truss' primary justification for the changes: the perceived hampering of the UK's inflation rate on the future value of damages payouts.

By comparison, it is arguable that the Australian climate is altogether different and in that sense insulated from any such drastic shakeups (at least for the short to medium-term future). For one, the nation was able to avoid a recession in the wake of the global financial crisis (and it appears that interest rates in Australia have bottomed out at a historic low of 1.5%).

Further, there was a major revision of Australian negligence laws in the early 2000s, following the country's own public liability crisis. The resulting legislation suggests that state governments are mindful of the impact that unfettered compensation can have on the insurance industry.

The NSW Government's changes over the past few years (both actual and proposed) to workers compensation and compulsory third party motor insurance ('green slip'), and the retaliation that followed from insurers, claimants and solicitors alike, provided a good learning also. It could be assumed from this that governments would be reticent to attract any further criticism through increases to green slips and insurance premiums.

The immediate backlash from key players in the UK insurance industry and related entities is thus apropos insofar as the Australian government would be remiss to make similar changes here without considered, strategic discussions with all stakeholders.

It should also be noted that the UK Government is launching a discussion in the second quarter of 2017

[3] Approximate number of weeks in twenty years

[4] Our estimate on the likely weekly multiplier for -0.5% discount, based on a comparison between the 3% and 5% and of the non-discounted figure. This resulted in the following calculation following 0.5(%) x 8 = 4(%); 1042.9 + 4%.

on whether there is a better or fairer framework for claimants and insurers, with a view to early legislation. Preliminary discussions for reform include talks on whether the discount rate should in the future be set by an independent body.

## Conclusion

The tables above serve to emphasise at least the hypothetical extent of analogous changes in the Australian context and the significant departure from the current norms that those changes represent. Despite that, the scope for similar changes to penetrate the Australian market is unlikely, as the country's specific socio-economic and political context must be taken into account.

While it remains to be seen whether Australian claimants and their solicitors will use the UK's approach to campaign for similar changes, it would be a bold, and perhaps ill-conceived, move for a state government to fly in the face of stability and make dramatic changes on its own accord.

As it stands, economic indicators show interest rates will rise globally (with Australia predicted to shift above its historic low of 1.5%). This combined with the very different political context of Australia compared to the UK leaves us confident that if any change were to be made to Australian discount rates, it would be modest.

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[1] https://www.willistowerswatson.com/en/press/2017/02/Comment-on-the-UK-Governments-decision-to-change-the-discount-rate-for-personal-injury-damages

[2] http://www.tradingeconomics.com/united-kingdom/interest-rate

[3] http://www.tradingeconomics.com/united-kingdom/interest-rate

[4] Paragraph 13.107, page 211of: https://www.treasury.gov.au/ConsultationsandReviews/Reviews/2002/~/media/Treasury/Consultations%20and%20Reviews/Reviews%20and%20Inquiries/2002/Review%20of%20the%20Law%20of%20Negligence/Key%20Documents/PDF/Law_Neg_Final.ashx

[5] Similarly, the discount rates in all other Australian states and territories hovers between 3-7%.

[6] http://www.telegraph.co.uk/business/2017/02/27/uk-insurers-hit-back-crazy-personal-injury-rate-change-share/

[7] https://www.abi.org.uk/news/news-releases/2016/12/abi-launches-legal-challenge-to-lord-chancellor

[8] https://www.theguardian.com/business/2017/feb/27/nhs-faces-new-1bn-annual-bill-after-reckless-change-to-injury-payouts

[9] https://www.solicitorsjournal.com/news/201702/lord-chancellor-cuts-personal-injury-discount-rate

[10] http://www.litigationfutures.com/news/truss-cuts-discount-rate-promises-review-along-help-nhs