ECONOMY, ENERGY AND FAIR WORK COMMITTEE

DAMAGES (INVESTMENT RETURNS AND PERIODICAL PAYMENTS) (SCOTLAND) BILL

SUBMISSION FROM: Personal Financial Planning Ltd

The Committee wrote to Personal Financial Planning Ltd to ask the following questions:

- Do you think the portfolio put forward in the Bill is suitable for the hypothetical investor, as also described in the Bill?
- The Bill allows for a 0.5% adjustment to the discount rate to take into account the impact of taxation and the costs of investment advice on the award. Do you think this accurately reflects the likely costs to the injured person?
- The Bill allows for a further 0.5% adjustment to protect against under-compensation due to investment volatility. What is your view of this further adjustment? Do you think it will provide the protection expected?
- The Bill allows for the discount rate to be reviewed at least every three years. How often would an injured person's investment strategy be reviewed, and what implications does this have for the proposals in the Bill?

On behalf of Richard and myself, our views on the points the Committee has raised are as follows:

The portfolio is in the real world, whereas the hypothetical pursuer is not. Therefore, there is a fundamental mismatch between the assumed portfolio and pursuers in the real world. To align the two, it would be necessary to make adjustments for systemic factors which undercompensate personal injury victims, notably discounts applied for litigation risk (most cases settle out of court), the inadequacy of the law in relation to claims for the capital cost of accommodation (which require the claimant to bear some or all of the cost), the inabliity to allow for real growth in earnings-based costs (above price inflation) and the risk of survival beyond an assumed date of death. As the Committee heard from the panel during the evidence session on 23rd October, pursuers start out with undercompensation, even if the statutory discount rate is set at the risk-free rate of return. The only objective measure of investment returns is the risk-free rate (index-linked gilts): any other measure is subjective and therefore there will be a range of opinions about suitability. Selecting any one of those opinions adds a further layer of systemic undercompensation. We do not therefore think that the portfolio put forward in the Bill is consistent with the 100% compensation principle also espoused.

With regard to the adjustment for tax, the hypothetical investor considered in the GAD report is likely to suffer a low (or no) rate of tax on income and capital gains, because the annual loss (and amount of capital) are modest. For catastrophic injury victims, whose income needs can easily run to £200,000 to £300,000 pa, tax has a far greater impact, and bites harder with time as more and more capital growth accrues through compounding. This can reduce returns significantly.

With regard to the adjustment for the costs of investment advice, there is an assumption in the GAD report that is often applied to investors generally: there is no point in paying for active investment management unless it delivers superior performance, i.e. the costs pay for themselves, if the performance is actually delivered. Therefore, on this basis, the assumption made is that the portfolio will be passively invested, not actively managed. However, this fundamentally misunderstands the nature of what pursuers require and must seek: that is not outperformance, but management of cash flows and risk. That management is an outright expense, and cannot end up delivering better than expected returns (only the market can do that). We would expect typical costs to fall in the range 1.5% to 2% in the real world, and for a portfolio of the size modelled by GAD the costs would be at the higher end of the range since it is only those with more capital who can generally expect to pay less in percentage terms for their advice.

The adjustment to protect against volatility is directly related to the point made above about the costs of investment advice, since reducing volatility is one of the purposes of the advice. Therefore, if the allowance for investment costs is adequate no further adjustment should be necessary.

An injured person's investment strategy would be under continuous review to assess his or her changing needs and changes in the world around them, and the impact of these on expected cash flows and investment risk. However, the discount rate is only ever relevant to an injured individual at the point of settlement - from their perspective it makes no difference how frequently the rate is reviewed. If the discount rate is set by reference to the risk-free rate of return the need for a review can be dispensed with by setting the parameters for a change relative to underlying changes in the yield on index-linked gilts (e.g. more than 0.5% in either direction). With a subjective portfolio as the basis for setting the rate, market conditions can shift rapidly and sharply, altering the risk of the portfolio either positively or negatively, and any review can only reassess according to current conditions, and the resulting rate is unlikely to meet the 100% compensation principle. That said, if the proposals are implemented a regular review is preferable to no review, or one as infrequent as has been the case since 2001.

We would also add the following comments in light of the evidence provided to the Committee at the hearing on 23rd October:

- Perhaps to a greater extent in England, but to a degree in Scotland too, the discount rate legislation is framed in terms of savings for consumers, in the form of lower insurance premiums, with PPOs as the safeguard for those who want certainty and security. In our view, this is a fallacy for two reasons.

- Firstly, consumers see the savings and perceive the upside of lower insurance premiums and, if they are fortunate, do not get to experience life as an accident victim and having to deal with undercompensation. Failure to recognise the risk of injury is a well-known cognitive bias, creating an argument that the State (Government) has a role to intervene and correct it.

- Secondly, if PPOs are to be encouraged, there is a failure to recognise that this will offset some of the saving for consumers from increasing the discount rate. For example, during the Third Reading of the Civil Liability Bill at Westminster on 23rd October 2018, Rory Stewart (Minister of State, Ministry of Justice) said of the current statutory discount rate "...*there are potentially not just hundreds of millions, but billions, of pounds of costs attached to the public Exchequer and through insurance premiums on the public themselves*" whilst going on to make the contradictory statement that "*In all cases we would encourage people to make much more use of PPOs*". PPOs impose additional costs on insurers compared to lump sum settlements. In the real world, defenders who are insured are extremely unlikely to be willing to provide them as they have greater financial incentive to settle on a lump sum basis: they can pay lip-service to PPOs but are able to refuse to offer them without jeopardy. Only public sector defenders can truly endorse and provide PPOs. For what it is worth, our experience in England & Wales has been that, in the last three years, PPOs were only offered in around 1 in 4 catastrophic injury settlements where the defendant was insured, which is around one-tenth of the number of public sector PPOs we have seen in the same period (roughly 20 insured PPOs per annum compared to 200 per annum in the public sector, in the cases we have seen, i.e. not the total number of PPOs done in any year). PPOs ought not therefore to be treated as a safety valve if the discount rate results in undercompensation. Furthermore, there should be recognition of and honesty about the effect on consumers of an increased take-up of PPOs (a policy that there was a significant degree of consensus about at the Committee hearing, and which we support).

- The notion of overcompensation seems to have been fuelled by the modelling that GAD was asked to do in both jurisdictions. It ought to come as no surprise that a person who is assumed to invest at higher risk than allowed for in the statutory discount rate has the opportunity for better and worse outcomes. The perception is that the better outcomes result in unjust enrichment to the individual or her estate. However, for the reasons given in evidence to the Committee and outlined in our response to the first question, individual pursuers must accept risk to seek 'more' simply to meet 100% of their needs. There is no actual evidence of overcompensation: it is impossible to gather it. Even if details of the estate of every injured person who has passed away were made available for scrutiny, without knowledge of spending decisions that were made during their lifetime and the actual cause of death no conclusion could be reached about under or over compensation. It therefore remains our view that the 100% compensation principle is not compatible with a discount rate set by assuming the pursuer must accept investment risk.