ECONOMY, ENERGY AND FAIR WORK COMMITTEE

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

SUBMISSION FROM: ASSOCIATION OF BRITISH INSURERS

COMMENTS ON THE GOVERNMENT ACTUARY’S DEPARTMENT ‘PERSONAL INJURY DISCOUNT RATE ANALYSIS’ FOR THE SCOTTISH GOVERNMENT PUBLISHED 5 SEPTEMBER 2018

We have now had the opportunity to consider the Government Actuary’s Department’s (GAD) report, dated 5 September 2018, Scottish Government: Personal Injury Discount Rate Analysis on the Damages (Investment Returns and Periodical Payments) Scotland Bill. We note particularly that the GAD was asked by the Scottish Government to:

- construct a hypothetical “low-risk” portfolio;
- analyse outcomes for pursuers in receipt of a lump sum award of damages for future financial loss under different PI discount rates and investment strategies – to inform the choice of the “further deduction” (i.e. the margin for prudence which will reduce the PI discount rate with the intention of improving the chances of the pursuer having sufficient funds to meet their damages); and
- comment on possible levels of allowance for expenses and tax.

We have already provided views in our response to the Call for Views and highlighted specific concerns about aspects of the Bill, which we considered would depart from the 100% compensation principle that must be inherent in the setting of the rate. The aspects which we considered would lead to significant over-compensation were:

- the content of the notional portfolio, which appears over-cautious;
- the assumption that the relevant period for investment is 30 years, which is too short; and
- the additional adjustment, which is described in the Bill as the "further margin".

The combination of an over-cautious portfolio and a shorter investment period reduces the protection against inflation that investment in Equities provides. Both issues need to be addressed in order to avoid distorting the outcome.

In providing these additional comments we have discussed the GAD Analysis with Pannells Financial Planning Ltd, a firm of independent financial advisers, whose report was attached to our response to the Call for Views.

Pannells, in their original report dated July 2018, stated that they would consider the notional portfolio "to be overweight in Fixed Interest Investments and underweight in Equities". They flagged that "Generally where an investment strategy is for an investor with a long term (16 years plus) time horizon the portfolio would contain a
higher exposure to Equity investments when compared to investors looking at investment over the shorter investment time horizons."

Pannells note that the alternative portfolios considered in the GAD Analysis do not differ significantly in the allocation of assets – particularly the equity exposure where the proposed baseline and alternative are equal.

The portfolio marked as "higher risk" includes 40% equities. Pannells consider that this remains within the tolerance of low risk investment. To illustrate the point, Pannells referred us to the Investment Management Association’s (IMA) and ABI investment sector classifications which are used to categorise investments suitable for different risk profiles. The lowest risk profile would involve a mix of between 0% and 35% equities; the next lowest would involve 20%-60% equities and many mixed investment funds in the latter would still be classed to be suitable for a low risk tolerance.

We asked Pannells whether the 20 funds considered in the GAD Analysis were a representative sample. Pannells was unable to answer this fully due to the limited information in the GAD Analysis as to the sector in which the selected funds sit or indeed whether the funds were selected using a specific metric such as using a volatility score. Their view was, however, that it was likely to be quite a restrictive sample and might itself represent an artificial restriction of the risk profile considered. They pointed out the number of investment funds incorporated within the IMA sectors mentioned, in respect of the Mixed Investment 0-35% Shares sector there are currently 56 funds and within the Mixed Investment 20-60% Shares sector there are currently 155 funds (source: Financial Express Analytics on 25 September 2018).

Pannells also pointed out that using a snapshot of the asset allocation of the 20 funds included in the sample to form the notional portfolio will essentially provide a reflection of the point in the economic cycle rather than what is suitable over a long-term investment horizon. For example, the funds chosen may be positioned to have a low exposure to UK Equities at the moment due to the potential impact of Brexit in the short term, however, this may be a temporary measure and does not reflect how the funds invest over the long term. They commented that when constructing the notional portfolio some reference to market studies\(^1\) that look at long-term asset allocations would be a better guide than taking a snapshot of the current position on 20 Multi-Asset funds.

Overall, Pannells retain the view that both the baseline (notional portfolio) and the alternative portfolio considered are underweight in equities – particularly where the investment period considered is over 30 years.

We specifically asked Pannells whether the fact that a pursuer has to realise assets over time would impact on the level of equities held for a given level of risk. Their view was that within a suitable diversified portfolio, this should not have any impact.

Pannells also commented on the use by GAD of the 75th centile for assessing the appropriate holding in ILGS, compared with their use of the mean that has largely been adopted for all other assets. They could not advise us of any obvious explanation for adopting this approach.

Overall, our view based on the GAD Analysis remains that the notional portfolio, and alternative portfolio considered are both over cautious. That view is supported by the additional comments from Pannells as well as their original report. An over-cautious approach creates a substantial risk of claimants being significantly over-compensated, especially where an excess of caution has been adopted on multiple points. A statute which provides substantial risk of significant over-compensation does not meet the fundamental principle of 100% compensation and would increase costs for the NHS and other public bodies, as well as insurers.

We have also considered Figure 8 in the GAD Analysis. This demonstrates the probability of under-compensation as against the median level of over-compensation for different award lengths. Unsurprisingly The chart shows that for a given discount rate approach (e.g. E[Real return] - 0.5%), the probability of pursuers being under-compensated and the expected level of over-compensation are sensitive to the assumed award period.

Broadly speaking, as the assumed award period increases:
- the probability of under-compensation decreases; and
- the expected level of over compensation increases.

This underlines the point that was made in our response to the Call for Views where we indicated that the 30 year period was significantly too short. ABI data demonstrates that the average investment period of 46 years is appropriate because it is the mean duration of future damages in those cases where the discount rate is a significant factor. The GAD report demonstrates clearly that if a more appropriate period of 46 years were to be applied, then the probability of under-compensation decreases. As such, an explanation as to the use of the 30 year period is required.

Applying a 30 year period impacts on the outcome and leads to a discount rate that is too cautious. When coupled with a notional portfolio, this over-cautious approach will undermine the 100% compensation principle and lead to pursuers regularly receiving more than 100% of the damages awarded to them, and the additional cost of this would be met by all compensators including the NHS and other public bodies in Scotland as well as insurance companies and their customers. That is before any additional adjustment is made for the "further margin" in the Bill.