SUBMITTING EVIDENCE TO A SCOTTISH PARLIAMENT COMMITTEE

DATA PROTECTION FORM

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<th>Name:</th>
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<td>Date:</td>
<td>August 2018</td>
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<td>Organisation: (if required)</td>
<td>Aviva Insurance Ltd</td>
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<td>Topic of submission:</td>
<td>Damages (Investment Returns and Periodical Payments) (Scotland) Bill</td>
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☒ I have read and understood the privacy notice about submitting evidence to a Committee.

☒ I am happy for my name, or that of my organisation, to be on the submission, for it to be published on the Scottish Parliament website, mentioned in any Committee report and form part of the public record.

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Non-standard submissions

Occasionally, the Committee may agree to accept submissions in a non-standard format. Tick the box below if you would like someone from the clerking team to get in touch with you about submitting anonymously or for your submission to be considered but not published. It is for the Committee to take the final decision on whether you can submit in this way.

☐ I would like to request that my submission be processed in a non-standard way.
We are broadly supportive of this Bill.

We fully support the principle of ensuring an injured party receives 100% compensation while balancing this with fairness to defendants in terms of cost.

However, there are certain aspects of the Bill which depart from the 100% compensation principle and would lead to over-compensation to pursuers. The cost of that over-compensation would be met by defenders including insurers, the NHS and other public bodies in Scotland – and therefore ultimately by Scottish taxpayers and Insurance customers. In particular, we highlight the following aspects of the Bill (on which we expand further in response to later questions):

- The notional portfolio set on the face of the Bill is overly-cautious
- The additional prudence adjustment in the Bill of 0.5%

The lack of statutory backing for PPO’s in Scotland has been a gap for a long time and one we understand and support the Scottish Government wishing to fill.

On the Discount Rate, our view is that there are considerable benefits to having a single rate applied across the UK. It is of course appropriate that Scottish Ministers have the power to set the Discount Rate in Scotland, as enshrined in the Bill, including the flexibility to set the same rate as set in England and Wales. Before commencing the process of setting a new rate, we would recommend that Scottish Ministers review the case for divergence with the England and Wales rate at that point in time. This may well avoid the need for a exercise that should – in theory – end up with the same conclusion, given that the investment strategy of a Scottish pursuer is highly unlikely to be any different from the investment strategy of an English or Welsh claimant.
Part 1

2. Part 1 of the Bill aims "to reform the law on the setting of the personal injury discount rate in order to make provision for a method and process which is clear, certain, fair, regular, transparent and credible". Is it an aim with which you agree? And to what extent do you believe the reform will achieve all these things – a clear, certain, fair, regular, transparent and credible method and process?

We agree with all these principles, apart from the principle of "certainty" where we do have some concerns.

In our view the only settlement mechanism that can fairly achieve certainty (in the sense of guaranteed payments at an agreed level and agreed escalation for life) is a PPO. If the courts have not imposed a PPO, and if a pursuer has elected to take a lump sum in preference to a PPO, then the pursuer is knowingly and willingly accepting some uncertainty. The PIDR cannot therefore be set with an aim of achieving "near certainty" - as this would materially over-compensate the vast majority of pursuers, at great cost to society in general (eg. Scottish insurance customers and Scottish taxpayers).

We think that "fairness" is a desirable principle, but believe that this must be viewed holistically, i.e. including the fairness of the mechanism insofar as it impacts society in general as well as pursuers. We think it would be reasonable for there to be “more chance than not” of a pursuer receiving sufficient compensation to cover future care costs for life, but there is a limit beyond which the extent of the certainty becomes unjustifiably unfair to defenders and therefore society at large.

We think a "regular" mechanism is desirable but would caution against a review period that may lead to dysfunctional behaviour in the market (e.g. where one party or the other “stalls” pending the publication of the next PIDR). The risk of this happening is intrinsically linked to how the PIDR is actually determined but given the nature of serious injury claims and the settlement process, a review period of 5 years (rather than 3 years) is likely to help mitigate this risk in our view.

We agree with the principles of clarity, transparency and credibility.

In terms of whether the proposed reform achieves these principles, we would make the following comments:

1. The evidence of real-world investment portfolios shows that the composition of the notional portfolio in the Bill itself is overly- cautious. The portfolio is overweight in Fixed investments and underweight in Equity investments and therefore the make-up of the notional portfolio does not reflect the real-word evidence submitted to the Government of the investments made by a low-risk investor.
2. The notional portfolio as currently composed would certainly mean that the resultant PIDR will give "more chance than not" of the lump sum proving sufficient. Therefore; it is clearly inappropriate to deduct the proposed 0.5% "further margin" to effectively err further on the side of prudence. This adds prudence on prudence, and would be unfair in the holistic sense discussed earlier – with Scottish insurance customers and Scottish taxpayers picking up the cost of over-compensation.

3. We think that it’s important to distinguish between the notional portfolio (which is purely a calculation mechanism) and real-world investment management that will occur in practice with lump sum awards. For example, in the real world, investment portfolios will virtually always be dynamic and managed (with assets not being held for the 30-year term that the notional portfolio assumes), and future investment real yields over the long term being more important than prevailing achievable real yields.

4. We are surprised to see the assessment that the notional portfolio detailed in the draft Bill could be concluded to lead to a 1% real yield “currently” (pre-deductions). We suspect that adequate account has not been taken of longer term expected real investment yields, and that the rate calculated as 1% currently is in effect a “spot rate” that takes no account of expected longer term yields. It is our view that a “spot rate” approach is inappropriate and will create volatility for pursuers and compensators alike. The approach set out in the Bill Schedule 3 para 25 “Returns-based assessment” indicates this is not the intended approach. We therefore do not understand the impact assessment view of 1% real yield “currently”.

Whilst we do not think that it would make sense to set a prospective PIDR purely on historic performance (which is not necessarily a guide to the future), we think this is a useful reference point. Our own analysis indicates that the notional portfolio would have achieved a real yield of c. 3% on average historically (again pre-deductions).

5. We think there are two factors that should be reflected in the calculations over and above the prevailing achievable real investment yields.

The first is a long-term outlook for future yields on the notional portfolio; we believe that it would make sense to assume "mean reversion" to this level over some time period (perhaps 5-10 years) rather than assume that prevailing investment yields will persist indefinitely. Based on our own view of a longer-term outlook we would assume in the region of 2.5% real yield for the notional portfolio (pre-deductions).

The second is a more fundamental recognition that any PIDR will on average be applied 2 or 3 years after the data on which it has been based was "current" (2 years hence if the review period is 3 years, and 3 years hence if the review period is revised to 5 years; noting that some averaging of recent historical data will be required to measure “current” yields, and the review itself will take some time to complete, so the delay is not simply half of the review period).
We think that taking account of these points will lead to both a more stable mechanism and a fairer mechanism. Taking account of the longer term will have a dampening effect on what may otherwise be more volatile PIDR's (with consequential risk of dysfunctional behaviour) and the removal of the “double-count” of prudence will calibrate the PIDR at what we believe is an appropriate level of “erring in favour of pursuers”.

In terms of the 0.5% deduction for management charges and tax, we think this is an appropriate and pragmatic assumption. Arguably the deduction could flex with the PIDR pre-deductions (so that there is a higher deduction if real yields are higher, and a lower deduction if real yields are lower). However, given the extent of estimation and judgement involved this probably would be a refinement too far.

In summary we would recommend:

i) Remove the double-count of prudence that is introduced by the 0.5% deduction
   ii) Use the proposed 0.5% deduction to allow for charges and tax
   iii) Form a view of long-term future real investment yields achievable on the notional portfolio, and assume mean reversion (from the corresponding prevailing real yields) to this long-term rate over an appropriate time frame
   iv) Reflect the fact that the PIDR will apply on average to settlements that will be made 2 or 3 years after it is set.

3. In terms of who sets the rate, the Scottish Government proposes to have the rate reviewed by the Government Actuary rather than Scottish ministers (as is the current situation). It believes that this will remove the setting of the rate from the political sphere “where there is the potential for pressure from external interests to attempt to influence the outcome” and “should provide fairness to all parties involved”. What are your views?

We do not believe the proposals are successful in removing the setting of the rate from the political sphere. The Scottish Government rightly retains the power to alter the notional portfolio and will need to exercise that power ahead of each PIDR review to take account of changing investment practice.

4. The Scottish Government has chosen to lay down in detail how the rate should be calculated in legislation. Do you support this proposal over the approach taken in England and Wales of leaving much more to the discretion of the Lord Chancellor and an expert panel?

While we welcome the clarity the Bill will bring, we have two main concerns:

1. If a different Discount Rate is set in Scotland to England, it would not reflect the reality of the investment choices of an injured party. The reality of course is there is no distinction as the very low risk portfolio to the investor is the same north or south of the border.
2. By adopting a more prescribed methodology than the proposed approach south of the border in the Civil Liability Bill this does tie the hands of the "rate-assessor" more than the hands of the Lord Chancellor/his expert panel. However, the Scottish Ministers whom the Bill gives a wide discretion to amend the legislation by regulations will have to keep on top of investment practice as the make-up of a suitable portfolio will change frequently depending on what is happening in the investment market. Indeed, in our view, if the legislation is going to prescribe the make-up of a suitable portfolio, the Scottish Ministers would need to reconsider the make up of the portfolio prior to each review.

An alternative approach would be to identify the make-up by reference to the asset allocation of an appropriate “independent” index such as the PIMFA Conservative Index.

5. With no statutory requirement for the discount rate to be reviewed regularly, currently there can be a 15 year gap between reviews in Scotland. The Government Actuary will start a review of the rate on the date on which the relevant provisions of the Bill are brought into force. Thereafter they will be required to start a regular review every three years and the Scottish Ministers may decide on an additional, out-of-cycle review, but which would not disrupt three-yearly reviews. Do you have any views?

We have two main observations:

1. A regular review using a consistent and transparent methodology is welcome. This should mean that any changes to rates should be incremental and avoid the disruption caused to all parties by a significant change.

2. We would recommend a 5 year rather than a 3 year review cycle. Claims of this type take an average of 3 years to settle and so a longer (5 year) interval would remove the risk of either party to a claim trying to speed up or slow down a case in anticipation of a favourable change in the rate. It would provide greater stability in the system by virtue of a rate that prevails for longer.

6. In changing the methodology to move away from a rate based on Index-Linked Government Stock (ILGS), the Bill makes provision “on the basis of portfolios described as cautious and which we believe would meet the needs of an individual in the position of the hypothetical investor who is described in the legislation”. The Scottish Government also states: “The portfolio does reflect responses to the consultation that investing in a mixed portfolio of assets provides flexibility and is the best way of managing risk”. Do you think the Scottish Government is justified in assuming that injured people have access to the necessary expertise to achieve this?

As discussed earlier we think that the notional 30-year term low risk portfolio results in an inbuilt level of prudence relative to real world investment outcomes. We believe
that the dynamic and managed nature of real world (still low risk) investment portfolios will on average outperform the real yield derived for the notional portfolio. Given this, there is no justification for the further margin adjustment of 0.5% which adds further prudence to an already prudent measure.

We also believe that it is reasonable to assume that pursuers have access to and are advised by those with the necessary investment management expertise, and indeed we are aware of investment managers who specialise in this area.

Part 2

7. Where damages for personal injury are payable, the Scottish courts may make a periodical payments order but only where both parties consent. This differs from England and Wales, where the courts have the power to impose such an order. Part 2 of the Bill will give courts the powers to impose periodical payments orders (PPO) for compensation for future financial loss. Respondents to recent consultations overwhelmingly supported courts in Scotland having the power to impose periodical payment orders, seeing this as a way of reducing uncertainty as well as the risk of over-/under-compensating pursuers. What is your position?

As per our original response we are broadly supportive. We merely repeat our response to Q12 of the original Periodical Payment Order consultation cautioning the cost of PPO’s to insurers and suggesting an alternative form of escalation:

Under the Solvency II regime, PPOs are expensive for insurance companies due to the quantum and duration of capital that needs to be held. In particular, capital is required over the lifetime of the PPO (which can be up to 90 years) to support uncertainty associated with pursuer longevity, allowance for the claims inflation index which the Scottish Courts may impose at S1(1B) and exposure to interest rates. In contrast, lump sum claim settlements pose the insurer no further risk and hence do not require capital post settlement.

Given this, it is important to note that the capital costs mean that the introduction of PPO settlements in Scotland will have a knock-on impact on the price of insurance.

We therefore think it is important to repeat our response to the Discount Rate consultation Question 32 and give the Scottish Government options for reducing the cost of PPOs. Our suggestion in the discount rate consultation is that it be mandated that settlement of PPOs be on an RPI linked escalation basis.

Capital costs for PPOs are particularly high in England because there is no way of managing the risks by matching PPO cash-flows with assets that generate returns directly linked to the ASHE 6115 escalation which is the most common inflationary index used. The ASHE 6115 index is considered ‘un-hedgeable’ and exposes the
insurer to material risks i.e. the risk that underlying PPO liability payments escalate at a higher rate than the returns generated on the supporting assets.

This could be addressed by settling PPOs on an RPI linked basis. This would allow insurers to hedge the escalation rate of the PPO liabilities via use of RPI linked assets or RPI swaps. If it was legislated that PPOs were required to escalate in line with RPI and assuming PPO propensity stayed at current levels, then the percentage benefit to Motor consumer prices could be in the low single digits (given the insurer still retains material long-tailed longevity risk) albeit this is sensitive to the propensity of PPO settlements.

In addition, PPO settlements on an RPI basis may enable GI insurers to demonstrate sufficient Asset/Liability Matching to be eligible for the Solvency II Matching Adjustment (MA) when discounting PPO liabilities (note currently no UK GI company has MA approval). This would effectively reduce the value of the PPO liability on the Solvency II balance sheet and could further reduce costs of PPOs.

In short, it would provide more certainty without the risk of increasing insurance costs to consumers.

8. How well used do you think the provisions would be in practice? What impact do you think the requirement on the court to ensure the “continuity of payment under such an order would be reasonably secure” would have?

On the basis of experience in England & Wales we make 3 observations:

Firstly, we believe that the take up of PPO’s in Scotland will be “slow burn” ie it will take some time for Scottish solicitors and Advocates to utilise this form of mechanism across the board. There will be some areas which push usage eg large clinical negligence claims via NHS Resolve and the MIB for uninsured drivers. Other areas however such as RTA or Employers Liability will likely exhibit a slower take up and will continue (as in England & Wales) to favour lump sum settlements – especially where the injured party wishes to “draw a line” and move on with his/her life.

Secondly, we do not believe, even when mature, that the number of PPO’s in Scotland will be significant – there is (thankfully) not a sufficiently large number of catastrophic injuries in Scotland to warrant this.

Thirdly, the uptake of PPO’s (or PPO Propensity) is directly related to the level of Discount Rate. In England, the reduction of the discount rate to -0.75% in March 2017 has reduced PPO Propensity down significantly. Data below from Aon Benfield* indicates propensity has reduced by c50%. The MIB in England (which being levy funded has a proactive policy of PPO settlements) in 2015 and 16 did 11-14 PPO’s a year. In 2017 with no change in policy at the MIB this has dropped to 5.

If the Scottish Government wishes this legislation to have a meaningful impact, the differential between PPO (say 0% discount rate) and a lump sum should be clear – the
PPO is the “no risk” choice while the lump sum is the “low risk” choice and clear difference must be there. The accompanying guidance to the Bill indicating that were the discount rate set on the basis as set out in the Bill today it would yield 0% would, in our opinion, render nearly irrelevant the PPO section of the Bill as rationally Pursuers would opt for lump sums and make a greater rate of return.

**Graph courtesy of Aon Benfield 2018**

9. The proposals in the Bill would allow the courts to revisit a compensation award where there has been a change of circumstances (although only where this has been identified in advance). This would represent a change to the current law. Do you have any comments?

The provisions on variation on the face of it introduce a very similar regime to the one that applies in the rest of the UK in that this mechanism only applies to a change in the pursuer’s medical condition (i.e. rather than a change in his circumstances) and requires a variable order to be made at the time of settlement.

We do think however that any change in the medical condition should be expressly linked to the injuries arising out of the act or omission which gave rise to the claim. This would, in our view, be in line with the approach adopted in the rest of the UK.

**Overall**

3. The Bill overall is intended to support the Scottish Government’s national outcome that: “We have strong, resilient and supportive communities where people take responsibility for their own actions and how they affect others”. Do you have any comment?
We only comment as to stress the need to balance the needs of adequately compensating (but not over compensating) the individual pursuer with the wider societal impact on consumers who ultimately (via insurance premiums, taxation etc) are responsible for the cost. As we have noted in our responses but particularly at Question 3 adding an additional factor for prudence to an already prudent approach does not meet this balance.

4. In previous consultations in this area, views have tended to be polarised between pursuer and defender interests. Does the Bill, in your view, manage to balance these interests?

In a legal environment where an adversarial approach is the norm and indeed Pursuers Agents can be rewarded via additional legal costs for creating disagreement there will always be polarised views.

Were the Scottish Government to introduce more pre/post action protocols and / or legal frameworks in which parties have to operate with associated fixed legal costs recovery then a more consensual, less polarised approach would more likely prevail.

We make reference above to the need for a stable and transparent process. This would be the greatest benefit to balancing pursuer and defendant interests. The dialogue between pursuers and defendants can only benefit from greater clarity on the mechanism by which the Discount Rate is set and how/how often it is calculated.

Other comments

5. Are there any other aspects of the Bill you wish to comment on?

None