ECONOMY, ENERGY AND FAIR WORK COMMITTEE

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

SUBMISSION FROM PERSONAL FINANCIAL PLANNING LTD

Damages (Investment Returns and Periodical Payments) (Scotland) Bill

Q6: Departure from risk-free rate of return

The statutory discount rate in both Scotland and England & Wales is presently based on index-linked government stocks (ILGS). They are the benchmark risk-free asset. That is because ILGS provide known cash flows, inflation-proofed relative to the RPI, with certainty.

From Figure 1, it is clear that the PIDR has never (during the application of the Wells v Wells approach) matched the ILGS redemption yield. The difference between the two is tracked over the period 2003 to 2018 with the PIDR as a dotted line and the redemption yield on ILGS as a solid curve.

Figure 1: The wedge between the PIDR and ILGS yields

The ‘wedge’ (vertical difference) between the two lines is the rate of return above the ILGS rate of return that the claimant needs to achieve to meet the stream of injury-related court-determined future losses/expenditures. Claimants must invest to meet the PIDR. Investment in ILGS would leave them short. Figure 1 shows average redemption yields since 2003 without any allowance for income tax, transaction costs or advice fees.

The wedge is widened by the fact that the application of the Roberts v Johnstone approach to the future accommodation usually leaves a material capital shortfall that the Claimant must meet by locking in lump sum damages into their property, with no means to release this capital in the future. This means that there is insufficient capital on day-one to meet all over the Claimant’s needs, even if the discount rate is achieved.
Additionally, many of the Claimant’s future needs will not increase in line with the RPI, but are earnings-based. Over time, earnings will rise at a faster rate than price inflation, increasing the size of the wedge.

The fact of the wedge is vitally important. It provides a competing explanation for the observation that claimants invest in risk-based portfolios. This explanation does not imply over-compensation. On the contrary, the wedge, and the response to the wedge, are indicators of under-compensation. Claimants need to make the ILGS return plus the wedge.

To do this they need to invest in risky assets. Acceptance of risk is the result of inability to afford the alternative, and not evidence of a willing trade in the hope of higher returns.

ILGS are the only assets capable of providing cash-flows risk-free: there is no volatility provided they are held to maturity. All of the other assets in the proposed notional portfolio have an element of risk, and expose the investor to volatility. This means the notional portfolio will either under or over compensate claimants. Briefing notes by Professor Wass and Ian Gunn (Submission EEFW/S5/18/DIRPP/05).

Risky assets are risky because of when they will lose you money. For example, when inflation overshoots expectations, low risk cash and fixed interest assets (cash or equivalents, nominal gilts, high-yield bonds and investment grade credit in this portfolio) provide no shelter for investors; the interest they earn and the capital invested will be eroded.

The highest risk is in assets with the longest duration: equities and long-dated gilts/bonds fit within this category and expose investors to the highest volatility. Broadly, their capital value is driven by the expected future income stream that ownership will provide, discounted to its net present value.

Given the cyclical nature of economies, and the fact that corporate profits are the most volatile element of GDP, most equities will do badly at the same time. However, it is the fact that equity losses will occur at just the time that makes it most painful for investors who own them that makes them risky. In other words, a portfolio does not exist in isolation.

For an ‘ordinary’ investor, the most crucial risk is losing money in the portfolio at the same time that cash flow from other activities is drying up. For the average person with a job and investments, losing money in your investment portfolio hurts, but losing your job hurts more. Losing both at the same time stinks.

Claimants who cannot work are even more likely to feel the pain of volatility. In other words, ‘correlation’ is what makes ‘risk assets’ risky.

Since economies are dynamic, and asset valuations are constantly in a state of flux, correlation between asset classes fluctuates over time. It is only by taking value into account that investors can make decisions (or be advised) where to allocate capital at any particular time to mitigate investment risks.

For example, the tables set out overleaf show the correlation between various asset classes over two time periods; the first from 31st December 1999 to 31st December 2007 and the second from 31st December 2007 to 31st December 2017.
<table>
<thead>
<tr>
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<th>Bloomberg Barclays Global High Yield</th>
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<th>FTSE All-Share</th>
<th>FTSE World Broad Investment Grade Bond</th>
<th>IA Sterling Corporate Bond</th>
<th>MSCI World</th>
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<td>FTSE All-Share</td>
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<tr>
<td>FTSE World Broad Investment Grade Bond</td>
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<td>1.00</td>
<td>0.70</td>
<td>-0.39</td>
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<td>IA Sterling Corporate Bond</td>
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<td>0.70</td>
<td>1.00</td>
<td>-0.05</td>
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<tr>
<td>MSCI World</td>
<td>0.68</td>
<td>-0.29</td>
<td>0.91</td>
<td>-0.39</td>
<td>-0.05</td>
<td>1.00</td>
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<tbody>
<tr>
<td><strong>31/12/2007 to 31/12/2017</strong></td>
<td>1.00</td>
<td>0.22</td>
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<td>0.20</td>
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<td>1.00</td>
<td>-0.07</td>
<td>0.56</td>
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<tr>
<td>FTSE World Broad Investment Grade Bond</td>
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<td>0.82</td>
<td>-0.07</td>
<td>1.00</td>
<td>0.45</td>
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The information is colour-coded for ease; the more blue the box the more correlated the assets, the more red the box the more un-correlated the assets.

One can clearly see the following from these tables:

- Since 2008 non-equity market correlation of the UK corporate bonds has become UK equity market correlation;
- Since 2008 non-equity market correlation of the UK corporate bonds, world investment grade bonds and UK gilts has become world equity market correlation; and
- The degree of non-equity market correlation of world investment grade bonds and UK gilts with UK equity markets has materially reduced.

Consequently, the degree of risk in the proposed ‘model' portfolio has, in our opinion, shifted upwards since 2008.

It is our understanding that the modelling of investment returns analysed by GAD keeps the asset mix in the portfolio constant over time, by rebalancing it. In other words, the notional portfolio is not reassessed over time by reference to holding its expected risk (or volatility) constant.

Q8: Take-up of PPOs.

Our experience in England & Wales has been of enthusiastic take up by health service and government bodies, and the MIB, because annual cash flows fit neatly with annual funding out of annual revenues. Furthermore, there is no requirement for these entities to hold actual capital reserves to meet future obligations.

The opposite has proved to be the case for defendants indemnified by insurers: in reality, high value claims will ultimately be covered by several reinsurance contracts. Both insurer and reinsurer are likely to find it cheapest to agree lump sum awards, and neither is structured or regulated in such a way as to make them particularly appropriate institutions to carry long term liabilities. Few insurers have positively embraced periodical payment and reinsurers tend to be at a distance from settlement negotiations. Unless that behaviour can be altered by appropriate incentives or disincentives it is unlikely that the proposed legislation will alter the current position.

Furthermore, for accidents where the defendant is indemnified under an employers’ or public liability insurance policy, the standard policy limit of £10 million may be adequate to cover a conventional lump sum where future losses are discounted to their net present value, but inadequate to cover the cumulative value of actual periodical payments over an individual’s expected lifetime. Continuity of payment in such cases may therefore fail the necessary tests to ensure it is reasonably secure.

We expect no different an experience in Scotland for both pursuers and defenders.
Security of continuity for PPOs is a fundamental requirement: it puts a lot of eggs in one basket and loss of income (or even delayed receipt) is likely to be catastrophic. We would point out that the FSCS protects contracts of insurance not insurers, and gaps in protection can arise.

The data is a sample taken from DMO data on 21st July annually between 2003 and 2017 updated 19th June 2018 from the Tradeweb Markets LLC data, which assumed responsibility for publication from the DMO after 21st July 2017. In line with previous practice, stocks with less than five years to maturity have been excluded, and the average redemption yield of the remainder has been calculated. No allowances have been made for income tax on nominal coupon receipts, transaction or advice costs, or investment management fees. Nor is there any allowance for the need to seek above-inflation returns to meet earnings-based costs and qualitative improvements in the future, both of which require acceptance of investment risk. Critically, the yield has not been averaged over the previous three or five years.