Association of British Insurers

Submission to the Committee for Justice call for evidence on the Damages (Return on Investment) (Northern Ireland) Bill

Executive summary

The Association of British Insurers (ABI) welcomes the introduction of this Bill to reform the methodology for calculating the Personal Injury Discount Rate (PIDR) in Northern Ireland. This reform is long overdue as the PIDR is currently set using an out-dated formula which does not reflect real-life circumstances. This means Northern Ireland is an outlier in both UK and international terms.

Plaintiffs and defendants need to see a more stable and fairer method for setting the PIDR. The Northern Ireland rate is about to swing from one extreme to the other under the current Wells-v-Wells methodology with limited incentive for one party to settle at either extreme. That is not fair or equitable, and requires reform urgently.

The ABI shares the Justice Minister's commitment to the principle of 100% compensation. This means both claimant and defendant are treated fairly in a settlement. As the Justice Minister Naomi Long MLA has said: "higher awards of damages are ultimately funded by businesses and consumers through higher insurance premiums, and by the taxpayer through higher payments made directly by, for example, the health service."[1]

However, the ABI does not support the decision by the Department of Justice (DoJ) to use the methodology based on the Damages (Investment Returns and Periodical Payments) (Scotland) Act as this does not meet the principle of 100% compensation which is fair to all parties. This Bill as introduced would have a significant financial impact on individuals and organisations that purchase liability insurance, and on compensators including insurers, organisations that self-insure, and public bodies including the Health and Social Care service in Northern Ireland.

[1] https://www.justice-ni.gov.uk/sites/default/files/consultations/justice/Personal%20Injury%20Discount%20Rate%20-%20How%20Should%20It%20Be%20Set%20a%20Consultation.pdf

Question 1: *Is the new statutory methodology to calculate the personal injury discount rate the most appropriate to achieve as close to 100% compensation as possible?*

No – the ABI does not believe the proposed methodology is the most appropriate to achieve as close to 100% compensation as possible.

Northern Ireland is the only jurisdiction in the UK persisting in using a flawed, out-of-date methodology to set a PIDR which leaves the country lagging behind the rest of the world.

The current PIDR in Northern Ireland is based on an incorrect assumption that a claimant invests all their damages in Index Linked Government Securities (ILGS) under Wells-v-Wells. As the evidence the ABI provided to the 2017 Ministry of Justice and Scottish Government consultation[2] on PIDR reform clearly demonstrates, no properly advised investor would invest solely in ILGS or indeed in any other single asset class. Retaining Wells-v-Wells and reducing the current PIDR to minus 1.75% makes Northern Ireland an outlier in UK and international terms with the lowest PIDR in the world. That has consequences for the liability costs borne by compensators in any serious injury claim.

The ABI and its member firms support the principle of full compensation, i.e. 100% compensation: not more and not less. The current law is not working properly to deliver that and the decision by the DoJ to introduce an interim PIDR of minus 1.75% will over-compensate claimants. It is essential that the PIDR methodology accurately reflects how pursuers are advised to invest their awards, and delivers a clearer system that strikes a fair balance between the interests of claimants and the requirement for affordable access to insurance.

Compensation in cases where people have suffered serious injuries through no fault of their own must be fair to the claimants but also to the defendants. Claimants must receive the compensation their injuries require to be paid, but that should not exceed the 100% principle. The civil justice system in Northern Ireland need to deliver fairness to all involved in such cases regardless of liability for the injuries being compensated.

The costs associated with paying people more than 100% compensation fall on insurers, and ultimately their customers; medical professionals; the Department of Health; Health and Social Care Northern Ireland; and other public bodies. It would also be borne by small businesses where claims exceed their insurance limit of indemnity. Ultimately the costs associated with that compensation approach would be met by Northern Ireland's consumers and taxpayers.

The new methodology is a welcome step away from Wells-v-Wells but we do not believe it is the most appropriate to achieve as close to 100% compensation as possible, as its calculations would be based on two positions adopted from the Damages (Investment Returns and Periodical Payments) (Scotland) Act 2019 which are designed to exceed the principle of 100% compensation.

In our submission to the DoJ consultation "The personal injury discount rate: How should it be set?" (attached as an appendix to this submission) the ABI recommended the adoption of the England and Wales methodology for calculating a PIDR for Northern Ireland as this would be a more equitable model. A majority of respondents to the consultation agreed[3], but the DoJ has chosen to proceed with the Scottish methodology and so we will focus our comments on that.

[2] https://consult.justice.gov.uk/digital-communications/personal-injury-discount-rate/
[3] https://www.justice-ni.gov.uk/publications/summary-response-personal-injury-discount-rate-how-it-should-be-set

The Bill adopts the further margin adjustment from the Scottish legislation which would reduce a PIDR recommendation from the Government Actuary's Department by a further 0.5%. The DoJ has not provided any evidence to show this further adjustment is required in order to achieve 100% compensation, and the ABI believes that including it in the Bill exceeds the target of 100% compensation and so it should be removed by the deletion of Paragraph 10(2)(b) from the Bill at line 21.

The Bill also adopts a notional investment portfolio (paragraph 12 of the Bill) from the Scottish legislation to be used to calculate the anticipated returns on those investments in order to set the PIDR for Northern Ireland. This notional investment portfolio is over-cautious and so will lead to a lower PIDR which will exceed the 100% compensation target.

The ABI urges the Committee to recommend the removal of the further margin and the review of the notional investment portfolio in order to adhere to the principle of 100% compensation.

Question 2: *Has the new methodology the potential to veer towards over compensation and if so how can this be rectified?*

The proposed methodology veers towards compensation of more than 100% and this can be addressed by removing the further margin and reviewing the notional investment portfolio.

The further margin adjustment is taken from the Damages (Investment Returns and Periodical Payments) (Scotland) Act 2019. The Scottish Government policy memorandum[4] in support of that legislation stated: "In changing the methodology away from a rate based on ILGS, the Scottish Government has made provision for a portfolio constructed on the basis of portfolios described as cautious and which the Scottish Government believes would meet the needs of an individual in the position of the hypothetical investor who is described in the legislation."

If a cautious portfolio is appropriate to meet the needs of the hypothetical investor, then this additional 0.5% adjustment downwards by definition goes beyond the needs of the pursuer and therefore beyond the 100% compensation principle. The notional portfolio adopted by the DoJ from the Scottish legislation is already over-cautious and the portfolio itself already risks departing from the principle of 100% or full compensation. The "further margin" adjustment is unnecessary and fundamentally undermines this principle. The over-cautious portfolio and the 0.5% further margin adjustment guarantee that the discount rate will deliver over-compensation to pursuers. There is no evidence in the Bill or supporting documents to support this policy decision. The ABI therefore propose that the further margin adjustment of 0.5% is removed in order for the Bill to adhere to the principle of 100% compensation.

The Bill also adopts the notional investment portfolio from the Scottish legislation. The ABI submitted a significant amount of evidence with its response to the 2017 MoJ consultation and shared this with the DoJ in its 2020 consultation. The analysis underpinning that evidence is not reflected in the notional portfolio included on the face of this Bill. The ABI has obtained further evidence as part of this response from Pannells Financial Planning, a firm of independent financial advisers (which is attached as an annex to this submission). Pannells' report includes details of asset allocation indices from various investment houses, but again, these do not reflect the notional portfolio.

Pannells' view is that the portfolio is overweight in Fixed investments and underweight in Equity investments. The notional portfolio is over-cautious and a portfolio which has more weighting to Equity investment would be more appropriate if the 100% compensation principle is to be upheld. Pannells

[4] https://www.parliament.scot/-/media/files/legislation/bills/previous-bills/damages-investment-returns-and-periodical-payments-scotland-bill/introduction/policy-memorandum-damages-investment-returns-and-periodical-payments-scotland-bill.pdf

highlight that Equity investments provide protection against inflation over the longer term. The longer the investment period of the portfolio, the greater capacity there is for the portfolio to smooth out the effects of short-term changes in the performance of equity investments. The ABI encourages the Committee to ask the DoJ to demonstrate the evidence for its policy decisions on the notional investment portfolio in the Bill.

As stated above, the costs associated with paying people more than 100% compensation would fall ultimately on Northern Ireland's consumers and taxpayers.

Question 3: *Has the new methodology the potential to veer towards under compensation and if so how can this be rectified?*

No – the proposed methodology does not have the potential to veer to less than 100% compensation. The ABI has not seen any evidence presented which demonstrates a problem with under-compensation.

Question 4: *Does the new statutory methodology reflect how a claimant would be advised to invest their award?*

Yes – the proposed methodology represents a low risk investor although the portfolio is too cautious. There is a lack of evidence on how claimants invest their compensation settlements.

As PIDR reforms in other UK jurisdictions have recognised, no properly advised pursuer would ever invest all their damages in ILGS. It is essential that the PIDR in Northern Ireland accurately reflects how claimants are advised to invest their awards, and delivers a clearer system that strikes a fair balance between the interests of claimants and the requirement for affordable access to insurance.

The ABI notes the submission from the Association of Personal Injury Lawyers (APIL) to the MoJ 2017 consultation[5] which said: "APIL surveyed its members and asked them about the type of financial advice they offered to their seriously injured clients.

"Sixty per cent of respondents indicated that their firm offers investment advice either in connection with lump sums, PPOs or both (56%). Only 11.85% of those offered the advice in-house: the majority (77.78%) referred their client to an external financial advisor while the remainder offered both options.

"We questioned the 40 percent who indicated that their firm did not offer financial advice to these clients to find out what they did instead. The vast majority strongly recommend that the client seeks independent financial advice, and then either refer them on to an IFA or, if it is a Court of Protection case, they may offer the services of an in-house or externally referred Deputy. None of the respondents appeared to leave their clients without either financial advice or a referral on to an IFA or other appropriate professional provider."

In its response to the DoJ's 2020 consultation the ABI encouraged the Department to commission research on the investment choices of claimants who have received compensation awards calculated using the PIDR to establish how they invest their lump sums and, if possible, how those investments have performed.

The ABI would expect claimant solicitors to be able to assist the Committee with this on behalf of their clients, as after a settlement is reach and an award is made then insurers have no further contact with claimants or insight into how they invest.

[5] https://www.apil.org.uk/files/pdf/ConsultationDocuments/3412.pdf

Question 5: *What are the likely effects of using an investment period of 43 years rather than 30 years in the model and do you agree with this approach?*

In 2017 the ABI provided the MoJ with an analysis of more than 2,500 settlements which shows the average investment period for a PIDR award is 46 years. Over this sort of investment period the risks of equity investments would be greatly reduced due to the ability for the portfolio to recover from short term volatility in financial markets. Equity investments also provide some protection against inflation over the longer term as the values of company shares would be expected to increase in real terms over time.

The ABI agrees with the use of an investment period of 43 years as reflects evidence of how seriously injured people invest their settlements and gives a longer period to smooth out investment performance. An investment period of 30 years is not based on evidence, does not reflect the real-world investment environment for low risk investors, and would significantly reduce the period of investment to achieve the returns sought, which would result in a lower PIDR than necessary.

•

Question 6: *What are the advantages or disadvantages of transferring responsibility for setting the rate from the Department of Justice to the Government Actuary and is there an appropriate level of accountability in the new statutory methodology?*

The Bill removes Ministerial responsibility and accountability from the process of setting the PIDR.

The framework for Scotland set out under the Damages (Investment Returns and Periodical Payments) (Scotland) Act 2019 is significantly more rigid and inflexible than the framework for England & Wales under the Civil Liability Act 2018. Under the Scottish framework the rate-setter's discretion as to the final rate is very limited.

The framework used in Scotland is based on a policy decision taken by Scottish Ministers to over-compensate claimants and as a result the PIDR in Scotland is set at a lower level than England and Wales. This generates additional costs for compensators including HSCNI and other public bodies as well as insurers.

The ABI recommends the DoJ follows the framework for England and Wales under which the PIDR rate is now set with reference to assumed returns from a diversified portfolio of low-risk investments, having regard to the actual investments made by claimants. This is better than the “cautious” investment approach and the statutory adjustments in the framework for Scotland which leads to overcompensation and the resultant additional costs borne by defendants including public bodies as well as insurers.

There must be political accountability for the decision to set a rate.

The ABI believes that the Justice Minister should have the power to exercise their judgement over the investment portfolio and any adjustments, but the Minister should be required by law to consult on these matters with an expert group. As set out above, this group should include economists, financial advisers and representatives for claimants and compensators in order that consideration is given to:

- The current and future economic environment
- Investment options and advice available to claimants and,
- How claimants actually invest their damages.

The ABI recommends that Northern Ireland should go further than the requirement in England and Wales where the expert panel consists of the Government Actuary, another actuary, an economist, a person with experience of managing investments, and a person with experience in consumer matters as relating to investments.

Additional points to note

The pricing of insurance premiums is a competitive decision for individual insurers to make for their respective books of business in Northern Ireland, and so the ABI is not able to provide any detailed analysis on the impact of a lower PIDR for buyers of liability insurance including drivers buying motor insurance, businesses and other organisations buying Employer's Liability and Public Liability insurance.

PIDR is a key component for underwriters calculating insurance premiums. The lower the PIDR is set, the more pressure this places on insurers' claims costs and, as a result, puts significant inflationary pressure on motor insurance premiums in Northern Ireland which are already higher than other parts of the UK due to specific local factors such as the costs involved in the civil justice system in Northern Ireland and higher road traffic accident rates.

Businesses in Northern Ireland are required by law to take out Employer's Liability insurance and many also take out Public Liability insurance to cover the cost of liability claims against them. A lower PIDR would put significant inflationary pressure on business insurance premiums at a time when Northern Ireland's businesses are facing the additional costs generated by COVID-19 and Brexit.

In addition to the inflationary pressure on premiums, a lower PIDR would also increase the level of liability cover a responsible business would seek to purchase. Businesses have previously bought around £2m worth of cover to meet the potential cost of a liability claim on the basis of a PIDR at 2.5%. A lower PIDR would push up the cost of compensation considerably which could more than double the scale of a compensation settlement as the DoJ's own consultation paper set out in the table below. Further examples to illustrate the effect of a lower PIDR on compensation settlements is set out in Annex A at the end of this submission. Businesses would therefore need to consider taking out a higher level of insurance cover or risk meeting the additional compensation costs from their own revenues.

Table 1: Effect of different discount rates on an award covering annual care costs of £100,000 for the rest of the claimant's life in two scenarios. [6]

Discount Rate	Total award	
	40-year-old male with normal life expectancy	10-year-old female with normal life expectancy
2.5%	£2,652,000	£3,475,000
1%	£3,611,000	£5,557,000
–0.25%	£4,876,000	£9,128,000
–0.75%	£5,566,000	£11,470,000
–2%	£8,005,000	£21,931,000

The ABI has seen no evidence that claimants in Northern Ireland invest their compensation awards in a different way or adopt different investment strategies to claimants in other UK jurisdictions.

The ABI notes the lack of a detailed impact assessment accompanying this Bill which is in contrast to the impact assessment provided by the Ministry of Justice in its equivalent legislation to reform the PIDR

[6] https://www.justice-ni.gov.uk/sites/default/files/consultations/justice/Personal%20Injury%20Discount%20Rate%20-%20How%20Should%20It%20Be%20Set%20a%20Consultation.pdf

methodology under the Civil Liability Act 2018. The MoJ impact assessment noted that setting the PIDR for England and Wales at minus 0.75% estimated an increase of £50-£75 on an average comprehensive motor insurance policy.[7]

The DoJ proposes using "an adjustment to the rate of return to take account of inflation by reference to the retail prices index or to an alternative source of information as prescribed by the Department in regulations subject to the draft affirmative procedure." The ABI believes the retail prices index (RPI) is the appropriate inflation measure to use in calculating the PIDR, on the basis it is accepted that RPI takes account of wages and owner occupier housing inflation as these are important factors in PIDR calculations.

The UK Government has announced its intention to replace the retail price index (RPI) with the consumer price index with housing (CPIH) by 2030[8] which would require the DoJ to amend this legislation (if passed by the Assembly) by that point. The ABI encourages the Committee to ask the DoJ how it plans to respond to this intended change.

About the ABI

The Association of British Insurers is the voice of the UK's world-leading insurance and long-term savings industry. A productive and inclusive sector, our industry supports towns and cities across the country in building back a balanced and innovative economy, employing over 310,000 individuals in high-skilled, lifelong careers, two-thirds of which are outside of London. Insurance supports 5,000 jobs in Northern Ireland and generates £539m per annum in Gross Value Added to the Northern Ireland economy.

The UK insurance industry manages investments of over £1.6 trillion, pays over £16 billion in taxes to the Government and supports communities across the UK by enabling trade, risk-taking, investment and innovation. We are also a global success story, the largest in Europe and the fourth largest in the world.

The ABI represents over 200 member companies, including most household names and specialist providers, giving peace of mind to customers across the UK.

[7] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/778252/Civil-Liability-overarching-impact-assessment.docx

[8] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/938008/RPI_Response_FINAL_VERSION_.pdf

Annex A - Illustrations of the effect of the PIDR on compensation settlements

These calculations make use of the updated 8th Edition Ogden tables provided by the Government Actuary's Department here. Please note that these are simplified examples and do not attempt to take account of awards made in respect of lost pension contributions or varying employment income over the subject's lifetime. Example 1 uses the split multiplier methodology set out in in the Ogden Tables explanatory notes and does not take account of possible future employment income for the subject.

	A 7-year-old girl is severely disabled in an accident and will require care of £100,000 per year up to the age of 11, £130,000 per year up to the age of 19 and £230,000 per year from the age of 19 onwards, with a stated life expectancy of 50 years.
Discount Rate	**Total settlement**
2.5%	£4,939,400
1%	£6,796,800
0.5%	£7,617,200
0%	£8,570,000
Minus 0.25%	£9,103,400
Minus 0.75%	£10,301,600
Minus 2%	£14,271,900

	A 30-year-old female is disabled in an accident and cannot work again. She has no educational qualifications and it is determined she would have earned £20,000 a year until retirement at 65. Her rest of life care is determined to be £100,000 a year.
Discount Rate	**Total settlement**
2.5%	£3,384,650
1%	£4,817,350
0.5%	£5,505,700
0%	£6,347,850
Minus 0.25%	£6,838,950
Minus 0.75%	£7,994,650
Minus 2%	£12,317,750

	A 25-year-old male is severely disabled in a car crash and cannot work again. He has a degree and it is determined he would have earned £50,000 a year until retirement at 65. His cost of care is going to be £30,000 a year for the rest of his life.
Discount Rate	**Total settlement**
2.5%	£2,060,715
1%	£2,822,030
0.5%	£3,175,800
0%	£3,601,500
Minus 0.25%	£3,847,000
Minus 0.75%	£4,415,910
Minus 2%	£6,486,605

The Scottish Personal Injury Discount Rate: How should it be set in the future

DAC Beachcroft Claims Ltd

July 2018

Produced by

Pannells Financial Planning Ltd

Contents

1 Purpose ... 3
2 Executive Summary ... 5
3 Background ... 6
4 Questions Raised by DAC Beachcroft ... 8
5 Responses ... 9
6 Conclusion ... 21
7 Appendices ... 22
Appendix 1 – Definition of Investment Risk ... 23
Appendix 2 – FE Invest ... 25
Appendix 3 – ABI Mixed Investment Sectors ... 28
Appendix 4 – ONS Life Expectancies Scotland ... 29

1 Purpose

This report has been prepared for DAC Beachcroft. The purpose of this report is to provide our answers to a number of questions raised by DAC Beachcroft relating to the recent draft Damages (Investment Returns and Periodical Payments) (Scotland) Bill in connection with the setting of the discount rate for compensation amounts awarded to personal injury claimants in Scotland.

Pannells Financial Planning Ltd (PFPL) is a firm of independent financial advisers established in 1989, and authorised and regulated by the Financial Conduct Authority (FCA). PFPL was previously PKF Financial Planning Ltd, a wholly owned subsidiary of PKF (UK) LLP. Following the merger between PFK (UK) LLP and BDO LLP in 2013, PKF Financial Planning changed its name to PFPL.

PFPL have a team of 21 regulated independent financial advisers who operate from 11 offices around the UK, this includes 3 Wealth Management Consultants and 1 Employee Benefits Consultant located in our Edinburgh and Glasgow offices. This report has been prepared by James Glass FPFS who is a Chartered Financial Planner and Certified Financial Planner based in the Edinburgh office, with 14 years of experience of working for independent financial adviser firms in Scotland including the last 7 years at PFPL in Edinburgh.

PFPL's mandate is to deliver highly specialised financial advice to companies, professional partnerships and individuals. PFPL has considerable experience of advising individuals on suitable investment strategies, this currently incorporates advising on assets under management in excess of £70 million for Scottish clients (as at April 2018). Depending on the nature of the engagement, a third-party investment manager or managers may be brought in to provide the investment management service.

Please note the following:-

- The scope of our work is based on instructions from DAC Beachcroft.
- We confirm that we have not entered into any arrangement where the amount or payment of our fees is in any way dependent on our opinion.
- We know of no conflict of interest of any kind, other than any which we have disclosed in our report.
- We do not consider that any interest which we have disclosed affects our suitability as an expert on any issues on which we have commented.
- We have shown the sources of all information we have used.
- We have exercised reasonable care and skill in order to be accurate and complete in preparing this report.

- The opinions we have expressed represent our true and complete professional opinions on the matters to which they refer.
- We do not accept nor assume responsibility if this paper is used for any other purpose or to any other person to whom this report is shown.

2 Executive Summary

- The notional portfolio prescribed on the face of the Bill is largely appropriate when undertaking a review of the discount rate given the assumptions that the rate-assessor is required to make.
- We do however believe that the portfolio is overweight in Fixed Interest investments and underweight in Equity investments.
- The investment time horizon assumed at 30 years would be classed as a long-term time investment period. Over this sort of time horizon the risks of Equity investments would be greatly reduced due to the ability to recover from short term volatility.
- Equity investments generally provide some protection against inflation over the longer term as you would expect the values of company shares to increase in real terms over time.
- The notional portfolio is appropriate for a cautious investor albeit that we would expect a portfolio over this time horizon to contain a higher exposure to Equity investments.
- We would expect most wealth managers to review/revise the asset allocation of their portfolios on at least an annual basis.
- A three-yearly review of the discount rate seems reasonable, but what constitutes a reasonable asset allocation is likely to change within that period and the notional portfolio on the face of the Bill would need to be assessed before each review to consider whether it remains appropriate.
- Underlying investment strategies applied in Scotland would tend to be comparable with those applied across the rest of the UK.

3 Background

The Scottish Government recently published the draft Damages (Investment Returns and Periodical Payments) (Scotland) Bill which is the result of its review of the interest rate used to calculate discounts applied to personal injury compensation in Scotland. This Bill will establish a system similar to that recently proposed in England and Wales under the Civil Liability Bill.

It is expected that following a pay out of a lump sum in compensation for future financial losses, expenses or costs resulting from personal injury or death, the capital will be invested and will yield income and that the capital over a period of time will reduce so that, at the end of the period, it is reduced to nil. This is referred to as the “100% principle”.

An appropriate multiplier is selected which will result in an appropriate annual rate of return. The rate of return is known as the discount rate.

The discount rate set by the Scottish Ministers in 2002 was 2.50%, with this set largely by reference to a 3-year average gross redemption yield of Index Linked Government Stock (ILGS). ILGSs were considered as a suitable investment for this purpose due to their low risk.

Our understanding of the Scottish Government’s approach is that claimants are placed in a special category of investors who need to be able to access their funds when required. However, they are assumed to only accept a low risk on investments, receiving a low rate of return. Whilst the claimant is free to invest their money as they wish, the discount rate is set to reflect this low level of return.

We understand that a typical claimant will require a return from investment over a long period, often 50 years or more.

ILGS had been in decline in recent years and there were concerns, prompting a joint Scottish Government and Ministry of Justice (MoJ) consultation, that the 2.50% discount rate was too high and that claimants were in effect being under compensated. To consider this matter a consultation paper was published on 1 August 2012 and closed on 23 October 2012. A report was subsequently produced for the Ministry of Justice (MOJ) in October 2015 by the Expert Panel.

Following a recent review of the discount rate, the Scottish Ministers announced the discount rate would be set at -0.75% which came into force in March 2017. This rate was based on a 3-year average of real returns on ILGSs.

The change of the rate led to renewed calls for the re-consideration of the way the rate is set. There is concern that the current approach intrinsically over-compensates many claimants and so goes against the 100% principle.

Following the most recent consultation in March 2017, the Scottish Government has prepared the draft Damages (Investment Returns and Periodical Payments) (Scotland) Bill.

This Bill incorporates a methodology using a low risk mixed investment portfolio approach to calculate the discount rate, introduces a review mechanism for the discount rate to be reviewed every 3 years by the 'rate assessor' who will either be the Government Actuary or a person appointed in place of the Government Actuary.

The Bill sets out the basis on which the rate-assessor is to make a determination of the rate. It states that a rate of return should reflect the return that could reasonably be expected to be achieved by a person who invests – (a) in the notional portfolio, and (b) for a period of 30 years.

The Bill also gives details of a hypothetical investor as someone:-

- Who is a recipient of damages, and will invest the damages, and do so as properly advised.
- Who has no financial resources, apart from the damages, that can be used to meet the losses and expenses for which the damages are awarded and will make withdrawals from the investment fund deriving from investment of the damages.
- Whose objectives are securing that the damages will meet the losses and expenses for which the damages are awarded and be exhausted at the end of the period for which the damages are awarded.

4 Questions Raised by DAC Beachcroft

Set out below are the questions raised by DAC Beachcroft who have been engaged by the Association of British Insurers to advise on issues relating to the new methodology for calculating the discount rate included in the draft Damages (Investment Returns and Periodical Payments) (Scotland) Bill. In preparing our replies, we have consulted with Investec Wealth & Investment Ltd on the basis that they manage monies awarded via personal injury compensation payments and we believe they are reasonably placed to offer some thoughts on the practical management of claimants' funds. We have also consulted with FE Invest who provide our in-house portfolio service for clients.

You would like our opinion on the following questions:-

1. **On the basis of the assumptions that the rate-assessor is required to make, do you consider that the notional investment portfolio on the face of the Bill is an appropriate one?**

2. **Does the notional portfolio reflect the portfolio that would be adopted by a cautious investor?**

3. **The Bill for England and Wales refers to a lower risk investor. The Scottish Bill is drawn by reference to a cautious investor. Is there any material difference between those terms?**

4. **Is the assumption of a 30 year period a reasonable assumption?**

5. **How frequently would you expect the fixed notional investment portfolio for a cautious investor to need revision? Please answer this by reference to the frequency of review of other published investment indices/other guidance provided to advisers.**

6. **The responses are considered from the perspective of a Scottish investor. The Bill requires the Government Actuary in England to conduct the rate assessment. Are there any factors to suggest that UK investors outside Scotland should be viewed differently, in terms of either investment behaviour or advice received?**

5 Responses

Our responses to the questions raised by DAC Beachcroft would be as follows:-

1. On the basis of the assumptions that the rate-assessor is required to make, do you consider that the notional investment portfolio on the face of the Bill is an appropriate one?

We have included the details of the notional investment portfolio included on the face of the Bill below:-

Asset Class	% Allocation
Cash or Equivalents	10%
Nominal Gilts	15%
Index-Linked Gilts	10%
High-Yield Bonds	5%
Investment-Grade Bonds	30%
UK Equities	7.50%
Overseas Equities	12.50%
Property (Heritable or Moveable)	5%
Other Types*	5%
Total	**100%**

** Examples of Other Types as mentioned in the table above are infrastructure, commodities, hedge funds and absolute return funds.*

Our understanding of the assumptions that the rate-assessor is required to make are as follows:-

- *A rate of return should reflect the return that could reasonably be expected to be achieved by a person who invests:-*

  a) In the notional portfolio; and

  b) For a period of 30 years.

- *Allowance must be made by the rate-assessor for the impact of inflation on the value of the return or investment to which the above point relates.*

- *The impact of inflation is to be allowed for by reference to, whether indicating an upward or downward trend:-*

  a) The Retail Prices Index within the meaning of section 833(2) of the Income and Corporation Taxes Act 1988; or

  b) Some published information relating to costs, earnings or other monetary factors as is, for use instead of the Retail Prices Index, prescribed in regulations made by the Scottish Ministers.

In addition to the assumptions above, there are also some standard adjustments included regarding Taxation and investment management costs.

Inevitably investment experts will come to different conclusions as to the most appropriate asset allocation to meet the above criteria. In our view however, the notional investment portfolio prescribed on the face of the Bill is largely appropriate when undertaking a review of the discount rate given the assumptions that the rate-assessor is required to make from a Scottish investors' perspective. The notional investment portfolio includes a well-diversified asset allocation and is largely akin to the type of portfolio that would be recommended for a personal injury claimant given the risk parameters assumed, we would however believe that the portfolio is overweight in Fixed Interest investments and underweight in Equity investments.

In terms of the investment time horizon assumed of 30 years, this would be classed as a long-term investment period which we would consider being 16 years or more. Over this sort of investment time horizon the risks of Equity investments would be greatly reduced due to the ability for the portfolio to recover from short term volatility and hence why we would advocate a higher Equity content. In addition Equity investments generally provide some protection against inflation over the longer term as you would expect the values of company shares to increase in real terms over time.

We have commented on the asset allocation of the notional investment portfolio in respect of Question 2 to follow.

2. Does the notional portfolio reflect the portfolio that would be adopted by a cautious investor?

We would view the notional investment portfolio included in the Bill to be well diversified and believe that this would largely reflect the type of portfolio that would be adopted by a cautious investor in Scotland, albeit we would consider this portfolio to be overweight in Fixed Interest investments and underweight in Equities. In our experience the range of investment strategies and associated asset allocations used in practice by discretionary fund managers or financial advisers do differ considerably from one investment manager to another, although the notional investment portfolio is similar to the investment strategy used in reality for cautious investors. We do not perceive any meaningful difference between investment strategies adopted by cautious/low risk investors in Scotland when compared to other parts of the UK.

We would expect the asset allocation for any investor adopting any investment risk profile to differ according to the investment term. Within Pannells FP Ltd we use differing investment strategies for time horizons spanning 5 to 7 years, 8 to 15 years and 16 years plus. 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.

We have expanded on our views of an appropriate asset allocation, incorporating input from Investec Wealth & Investment Ltd, FE Invest and drawing on the current asset allocation for the FTSE UK Private Investor Indices.

You will note from the information included below that the asset allocations included for the FTSE UK Private Investor Indices and FE Invest contain higher Equity content and lower Fixed Interest content when compared to the notional portfolio in the Bill. However, the notional investment portfolio asset allocation is closer to that currently favoured by Investec as a starting point for a cautious investor.

Investec Wealth & Investment Ltd

Investec apply benchmarks for their portfolios that are broadly based on the FTSE UK Private Investor Indices, details of which for a cautious investor are noted later in this report. You will however note that there are currently some significant differences between Investec's current asset allocation versus the FTSE UK Private Investor Conservative Index at the moment.

In broad terms, for a cautious risk investor seeking a return from a combination of income and growth the asset mix could be as follows:-

Asset Class	Investment Sector	Weighting	Asset Class Weighting
Fixed Interest:-			**57.0%**
Near Cash	Low Volatility Bond Funds	2.0%	
Insurance	UK Gilts	13.0%	
	UK Index-Linked Gilts	10.0%	
	Global Government Bonds	7.0%	
Credit Risk & Emerging Markets	Investment Grade Corporate	15.0%	
	High Yield Bonds & EM	10.0%	
Equities:-			**14.0%**
UK Equities		6.0%	
Overseas Equities		8.0%	
Commercial Property:-			**10.0%**
Alternative Investments:-			**15.0%**
Structured Products		5.0%	
Absolute Return/Hedge Funds		5.0%	
Other (e.g. Infrastructure)		3.0%	
Gold/Commodities		2.0%	
Cash:-			**4.0%**
Total			**100.0%**

(Source: Investec Wealth & Investments UK in July 2018)

This portfolio is a guideline for investment managers and would be a starting point for discussion with the client.

FTSE UK Private Investor Indices

Many wealth managers refer to the FTSE UK Private Investor Indices for guidance to construct an appropriate asset allocation for investors. These benchmarks provide:-

- A basis for discussing and reviewing the asset allocation and structure of a portfolio with the fund manager or stockbroker.
- A benchmark for assessing and comparing the performance of discretionary fund managers.
- A measure to compare the performance of similar Income, Growth and Balanced based funds.

Of the indices provided, it is likely the Conservative and Income Indices would be considered for cautious or low risk clients. The current asset allocation for these indices is as follows:-

Asset Class	Conservative Index		Income Index	
	Weighting	Asset Class Weighting	Weighting	Asset Class Weighting
Fixed Interest:-		**44.9%**		**31.1%**
- UK Government Bonds	7.3%		6.3%	
- Sterling Corporate Bonds	8.4%		6.0%	
- Global Bonds	29.2%		18.8%	
Equities:-		**30.7%**		**47.1%**
- UK Equities	9.7%		15.9%	
- Global Developed Markets	21.0%		31.2%	
Commercial Property		**1.3%**		**1.3%**
Alternative Investments		**9.4%**		**9.5%**
Cash		**13.7%**		**11.0%**
Total		**100.0%**		**100.0%**

(Source: FTSE Russell in April 2018)

Pannells Financial Planning Ltd / FE Invest

As independent financial advisers, we advise clients on portfolio construction with emphasis on using a diversified portfolio suitable for the level of risk the client wishes to take. For portfolios worth more than £100,000 we are likely to use model portfolios provided by FE Invest (FEI). In broad terms these portfolios aim to maximise returns for a given level of risk over a set time horizon. The asset allocation is provided by a stochastic modelling from EValue which provides a suggested asset mix that is suitable for each forecasted volatility level. FE analyse the observed volatility of each asset mix over a range of time periods and use this as a guide when constructing the portfolios. The asset mix and underlying fund choice is reviewed biannually. Please refer to **Appendix 2** for details of FE.

Note that EValue alters the asset allocation according to the investment term. This is because short term fluctuations in higher risk asset classes are likely to be less impactful the longer the investor is intending to invest for.

The current portfolio asset allocation for a cautious and moderately cautious risk investors over the long term (16 years plus) is as follows:-

Asset Class	Cautious	Moderately Cautious
Alternative Investments	10.0%	0.0%
Cash	0.0%	0.0%
Fixed Interest	40.0%	40.0%
Global Developed Equity	25.5%	45.0%
UK Equity	19.5%	5.0%
Property	5.0%	5.0%
UK Smaller Companies	0.0%	5.0%
Total	**100.0%**	**100.0%**

(Source: FE Invest in April 2018)

In the case of Personal Injury compensation, it is likely that the Pursuer will require a regular stream of income. Where we advise clients who are in this position (for instance drawing their retirement income from the invested funds) we would normally recommended the first 2 to 3 years' income is held in cash. Therefore, the actual asset allocation for a client in the position the Rate Assessor is required to consider might look as follows:-

Asset Class	Cautious	Moderately Cautious
Alternative Investments	9.0%	0.0%
Cash	10.0%	10.0%
Fixed Interest	36.0%	36.0%
Global Developed Equity	23.0%	40.5%
UK Equity	17.5%	4.5%
Property	4.5%	4.5%
UK Smaller Companies	0.0%	4.5%
Total	**100.0%**	**100.0%**

We do not differentiate the investment strategy or asset allocation adopted for our clients based on their geographical location in the UK, therefore the strategic asset allocation used for Scottish investors is the same as that used by our colleagues located in the 9 PFPL offices in England.

We would also consider investments funds within the following ABI Sectors:-

- ABI Mixed Investment 0%-35% Sector

- ABI Mixed Investment 20%-60% Sector

ABI Sectors exist to enable investors and advisers to compare unit-linked life and pension funds. Please refer to **Appendix 3** that contains details of these sectors, but in broad terms funds within these sectors have portfolios invested in a diversified portfolio with a cap on Equity exposure.

3. The Bill for England and Wales refers to a lower risk investor. The Scottish Bill is drawn by reference to a cautious investor. Is there any material difference between those terms?

We do not believe that there is any material difference between the terms of lower risk investor and cautious investor. In our view these terms are interchangeable, and they are based on a similar investor profile prescribed within the respective Bills.

With regard to categorising risk appetite for any investor, this is subjective and based on a number of factors relevant to the client, including:-

- Assets/liabilities
- Income/objectives
- Risk tolerance
- Capacity for loss
- Capital expenditure plans
- Investment term

In addition we do not perceive any meaningful difference in attitudes to investment risk between Scottish investors and those in the wider UK, whilst the methodology used and risk assessment systems (such as Dynamic Planner, FE Analytics and Morningstar) do not differentiate risk due to geographical location in the UK.

We have included the Pannells FP Ltd definitions of investment risk within **Appendix 1** at the end of this report.

4. Is the assumption of a 30 year period a reasonable assumption?

We would suggest that the assumption of a 30 year period for investment is a reasonable assumption . Whilst some personal injury claimants will potentially have investment periods of longer than this or indeed shorter than this on a 'rest of life' basis, we would agree with the suggestion in the Government Actuary's Department (GAD) report of 19th July 2017. This suggests that the 30 year assumption would sit somewhere between "short" awards (for example given to those with severe injuries, lower life expectancy or older claimants) and "long" awards (for example given to younger claimants).

It is worth noting that life expectancies have been increasing generally and therefore there is the potential for claims to cover longer periods in theory, although this could clearly be impacted by the injury suffered resulting in the personal injury claim. I have included details of life expectancies in Scotland within **Appendix 4** at the end of this report.

We would note that a longer investment time horizon which we would class as being 16 years plus allows a greater risk tolerance as if there is a negative market event there is less chance that substantial capital needs to be sold at a disadvantageous time.

5. **How frequently would you expect the fixed notional investment portfolio for a cautious investor to need revision? Please answer this by reference to the frequency of review of other published investment indices/other guidance provided to advisers.**

In our experience most wealth managers would review/revise the asset allocation of their portfolios on a 6-monthly or annual basis, this may take the form of differentiating between long term strategic asset allocation reviews and shorter term tactical asset allocation reviews.

We would therefore generally expect the asset allocation models used by most wealth managers to be reviewed at least on an annual basis and perhaps more regularly, although whilst asset allocation reviews may take place on a 6-monthly basis most wealth managers would only meet with a client once a year when the asset allocation and investment strategy would be revised in their portfolio. Generally asset allocation models would be reviewed on a regular basis in order to take account of changing investment market and economic conditions and the impact this has on long term return expectations and risk.

It is worth noting that some of the key companies that drive thinking about asset allocation and investment strategies for wealth managers are based in Scotland, for example some of the large insurance companies such as Standard Life, Prudential and Scottish Widows have a significant presence in Scotland. Also Edinburgh has a large number of fund management houses, second only to London in the UK, with many of the multi-asset funds used widely throughout the UK and we have expanded on this point under Question 6 to follow.

We have included some commentary below on the approaches taken to the frequency of asset allocation reviews below.

Investec Wealth & Investment Ltd

Investec provided the following comments on their asset allocation reviews:-

"We review our strategic (long-term) asset allocation for portfolios on an annual basis, and also should the situation arise that it is appropriate to do so sooner than annually then we will also adjust it on an ad-hoc basis, although this would be unusual.

Our Asset Allocation Committee sits monthly to review our tactical (short-term) asset allocation. Again, if they need to sit additionally to these systematic meetings they will do so but it is again unusual as we do not wish to undertake knee-jerk reactions.

Investment Managers then review and manage clients' asset allocation from a practical perspective on an ongoing basis."

We included the asset allocation used by Investec in our previous report of May 2017, when comparing the current asset allocation with the one from May 2017 the following changes have occurred to their low risk portfolio:-

Asset Class	Investec Low Risk Portfolio Differential (+ or -)
Alternative Investments	+ 4.0%
Cash	- 6.0%
Fixed Interest	+ 2.0%
Global Developed Equity	+ 1.0%
UK Equity	- 3.0%
Property	+ 2.0%

(Source: Investec Wealth & Investment Ltd in July 2018)

As you can see from the information above there have been some meaningful changes in the asset allocation adopted by Investec for a low risk investor in the period between May 2017 – July 2018.

Pannells Financial Planning Ltd / FE Invest

The asset allocation reviews on the portfolios that Pannells FP Ltd use from FE Invest are undertaken on a 6-monthly basis in April and October each year, with the following table showing the asset allocation changes for the cautious and moderately cautious portfolio from the previous review:-

Asset Class	Cautious Differential (+ or -)	Moderately Cautious Differential (+ or -)
Alternative Investments	No Change	No Change
Cash	No Change	No Change
Fixed Interest	- 4.5%	+ 1.5%
Global Developed Equity	- 5.0%	+ 4.0%
UK Equity	+ 9.5%	- 5.5%
Property	No Change	No Change
UK Smaller Companies	No Change	No Change

(Source: FE Invest in April 2018)

Once again there have been some meaningful changes to the investment strategy adopted in respect of the above risk profiles during a 6-month review period.

Whilst the asset allocation of our portfolios is reviewed on a 6-monthly basis we would normally only undertake a review meeting with a client once a year when the most recent asset allocation would be implemented into their portfolio.

FTSE UK Private Investor Indices

In terms of the FTSE UK Private Client Investor Indices, the asset allocations are reviewed on a 6-monthly basis in March and September each year. These reviews are based on Morningstar data as at the close of business on the last business day of the previous quarter. The new asset allocations are implemented after the third Friday of March and September. In June and December, each of the Private Investor Indices will be reweighted to the asset allocation levels set in the immediate prior review.

As with the Investec asset allocation, we also included the asset allocation data for the FTSE UK Private Client Conservative and Income Indices within our report of May 2017. We can therefore provide the following summary of changes within their asset allocations during the interim period:-

Asset Class	Conservative Index Differential (+ or -)	Income Index Differential (+ or -)
Alternative Investments	- 8.1%	- 3.0%
Cash	+ 8.7%	+ 6.0%
Fixed Interest	+ 4.9%	+ 6.1%
Global Developed Equity	+ 7.5%	+ 11.2%
UK Equity	- 9.3%	- 16.6%
Property	- 3.7%	- 3.7%

(Source: FTSE Russell in April 2018)

Clearly the increased volatility experienced in global investment markets in Q1 2018, the impact of interest rates rising in the US, Brexit and changing medium to long term views on economic and market conditions will have been factors in the asset allocation changes noted above. This follows a period of very low volatility in investment markets in the preceding 12-18 months before Q1 2018.

I have included some information below on the performance of the FTSE UK Private Investor Indices and ABI sectors below:-

The following table provides details of the discrete performance of each of the constituents above during 12 month periods over the last 5 years:-

Name	30/06/2017 to 30/06/2018	30/06/2016 to 30/06/2017	30/06/2015 to 30/06/2016	30/06/2014 to 30/06/2015	30/06/2013 to 30/06/2014
ABI Mixed Investment 0-35% Shares	0.75%	5.30%	3.70%	4.23%	5.01%
ABI Mixed Investment 20-60% Shares	1.77%	10.51%	0.95%	4.11%	5.71%
FTSE UK Private Investor Conservative	3.66%	7.83%	8.46%	7.42%	6.07%
FTSE UK Private Investor Income	4.85%	11.11%	7.66%	6.67%	8.02%

(Source: FE Analytics in July 2018)

Clearly it may not be practical or cost effective to review/update the fixed notional portfolio for a cautious investor included within the Bill and undertake the associated discount rate review by the rate-assessor on an annual basis. This would potentially raise issues in respect of personal injury cases that can last for several years and allow 'gaming' within the system. Therefore an approach of reviewing the asset allocation on a 3-yearly basis seems reasonable, albeit the asset allocations used by wealth managers can change significantly during relatively short periods as demonstrated by some of the information earlier in this section.

We would suggest that this is perhaps a question of whether the disadvantages associated with delays in reviewing the asset allocation/discount rate outweigh the potential disadvantages of an incorrect discount rate being used for what could be a couple of years in the event of significant asset allocation changes between discount rate reviews taking place.

6. **The responses are considered from the perspective of a Scottish investor. The Bill requires the Government Actuary in England to conduct the rate assessment. Are there any factors to suggest that UK investors outside Scotland should be viewed differently, in terms of investment behaviour or advice received?**

Overall we do not believe that there are factors that would mean that UK Investors invest differently from their Scottish counterparts. Most wealth management firms in the Scotland are part of organisations that work throughout the UK and therefore asset allocations and investment strategies tend to be applied firm wide and dictated by a centralised investment committee.

It is worth bearing in mind that some of the key companies that drive thinking about investment strategies for wealth managers throughout the UK are based in Scotland and have a large presence here, for example some of the largest UK insurance companies such as Standard Life, Prudential and Scottish Widows. Also some fund managers used throughout the UK who offer multi-asset funds are also based in Edinburgh, including Aberdeen Standard Investments, Artemis, Baillie Gifford, Cornelian, First State Investors, Kames and Franklin Templeton. Therefore it is actually likely that these Scottish insurance companies and fund management houses will impact on investment strategies adopted throughout the UK.

In terms of the investment strategies used by Pannells FP Ltd for cautious/low risk investors, these do frequently incorporate collective investment funds managed by the above noted Edinburgh based fund management houses and in particular Baillie Gifford and Cornelian are widely used. In addition funds managed by all of these fund management houses are included on the FE Invest list of ‘approved’ funds which we utilise. As noted earlier, a consistent investment strategy is adopted for our clients regardless of whether they are advised by a Wealth Management Consultant in one of our 9 offices in England or by the 3 of us based in the Edinburgh or Glasgow offices.

We have experienced situations where Scottish clients have expressed investment preferences based on geopolitical views, such as their views on Scottish independence from the UK, and their preference to favour Scottish based fund management houses and/or investments in Scottish companies. However, this is very rare in our experience and once a thorough discussion of the potential limiting factors and risks associated with focussing an investment strategy on geographical location due to political biases, these views are generally altered. Clearly it is also possible that clients in the rest of the UK could also have investment biases due to political views or geographical focus and therefore we certainly do not believe that this is an investment behaviour restricted to Scotland, albeit it may be slightly more prevalent in Scotland since the 2014 Scottish Independence Referendum.

There are clients that we deal with who would have holdings in some of the Scottish domiciled Investment Trusts and these are fairly widely used amongst discretionary fund managers for Scottish investors. However, the underlying investment strategies within these would tend to be largely comparable with the investment strategies adopted by Investment Trusts and other Collective Investment Funds (Unit Trusts and Open Ended Investment Companies) throughout the rest of the UK.

We therefore do not expect that this would result in significantly different outcomes for a Scottish investor when compared to those in the UK outside of Scotland.

Lower life expectancies in Scotland may be perceived to result in Scottish investors investing differently from their counterparts in the rest of the UK, however, in our experience this is not the case as most investors would be investing funds for a long-term investment horizon and a few years difference in life expectancy would not impact on a long-term investment strategy.

6 Conclusion

This report deals with the questions raised by DAC Beachcroft to assist with their engagement with the Association of British Insurers to advise on issues relating to the draft Damages (Investment Returns and Periodical Payments) (Scotland) Bill.

In our view the notional investment portfolio prescribed on the face of the Bill is largely appropriate when undertaking a review of the discount rate given the assumptions that the rate-assessor is required to make. The notional investment portfolio includes a well-diversified asset allocation and is largely akin to the type of portfolio that would be recommended for a personal injury claimant given the risk parameters assumed, we would however believe that the portfolio is overweight in Fixed Interest investments and underweight in Equity investments.

In our experience most wealth managers would review/revise the asset allocation of their portfolios on a 6-monthly or annual basis, although these changes may not be implemented to the investment portfolio held by a client until the next scheduled annual review meeting.

We do not believe that there are factors that would mean that UK investors outside of Scotland invest differently from their Scottish counterparts. Most wealth management firms in the Scotland are part of organisations that work throughout the UK and therefore asset allocations and investment strategies tend to be applied firm wide and dictated by a centralised investment committee.

Should you require any further clarification on any of the points raised please do not hesitate to us.

Pannells Financial Planning Ltd

7 Appendices

Appendix 1 – Definition of Investment Risk

Extremely Cautious

You are extremely cautious and do not wish to take risk with your capital at all. You understand that by adopting this approach the real value of your money may fall when taking into account inflation, but for you this is preferable to your money falling in actual value.

Cautious

You would like your investments to have the potential grow at a rate greater than is available from deposit accounts and are willing to accept the risk of a small level, maybe by 5% in a year, of capital loss to achieve this. You are looking for an investment that is expected to be more stable and fluctuate in value far less than company shares and so is likely to involve a very high proportion of fixed interest assets, property and some cash. As a consequence, you accept that the investment return is likely to be much lower. You appreciate that over some periods of time the value of your investment can fall and you may get back less than you invest.

Moderately Cautious

You would like your investments to grow so that they have the potential to provide real returns in excess of inflation and are willing to accept the risk of some capital loss, maybe by 10% in a year, to achieve this. You are looking for an investment that is expected to fluctuate in value less than company shares and so is likely to involve a significant proportion of fixed interest and property assets. As a consequence, you accept that the investment return is likely to be lower. You appreciate that over some periods of time the value of your investment can fall and you may get back less than you invest.

Balanced

You are looking for an investment with the potential to produce good returns above inflation but with less fluctuation in value compared to company shares alone. While investing in company shares and property often gives the best potential for growth, you wish to limit the amount you invest in these areas. You appreciate that over some periods of time the value of your investment will fall, maybe by as much as 20% in a year, and you may get back less than you invest.

Moderately Adventurous

You would like your investments to grow significantly in excess of inflation and are willing to accept the risk of large capital losses, maybe as high as 30% in a year, to achieve this. In order to achieve high levels of return it is likely that the majority of your investments will be in UK and International company shares that may fluctuate sharply in value. You appreciate that over some periods of time there can be sharp falls, as well as rises, in the value of your investment and you may get back less than you invest.

Adventurous

You wish to maximise the potential growth from your investments and are willing to suffer very significant capital losses to achieve this. These losses may be as high as 40% in any one year. In order to achieve high returns it is likely a large proportion of your investments will be invested in International company shares, including those in companies based in less developed economies. You appreciate that over some periods of time there can be significant falls, as well as rises, in the value of your investment and you may get back less than you invest.

Appendix 2 – FE Invest

Financial Express (FE) is an independent company specialising in the collection, categorisation and data-basing of investment data and is one of the leading providers of performance data and analysis tools to the investment industry with a strong presence in Europe and Asia Pacific. FE's clients in the UK currently include Zurich, Aberdeen Standard Life Investments, Aviva and Quilter Investors amongst many other major blue chip clients.

FE Invest uses institutional quality analysis to create and monitor the FE Invest Approved funds and the FE Invest Portfolios.

FE Invest Approved funds

FE Invest Approved is a list of 100 funds covering all sectors and asset classes that are chosen with the aim of outperforming their peers.

Fund Selection

The FE Invest Approved funds are chosen with reference to the following criteria:

FE Crown ratings**.** This is a quantitative measure of risk adjusted returns announced in January and July.

FE Alpha Manager Ratings**.** This assesses the risk adjusted returns of fund managers over their career taking into account all the funds managed, compared against their relevant peers. It analyses whether managers do well or badly in any particular type of market i.e. rising or falling. The aim is to identify managers who consistently outperform. The awards are made each July.

FE Group Awards**.** This is an annual assessment of a fund group's cumulative crown ratings in specific asset classes over the previous 3 years. Groups that can demonstrate significant outperformance against their peers are assigned 'Outstanding' or 'Highly Commended' ratings.

Adviser Fund Index**.** This takes into account the funds being recommended by leading financial advisers.

The FE Group criterion has 20% less weight than the others to avoid predominance with a limited number of fund managers. In addition funds that meet the criteria but are very closely aligned with other funds that are managed by the same manager in the same asset class are removed to maximise diversification. Finally funds are also assessed for transparency with those unable to disclose certain information marked down.

In addition to this quantitative foundation FE has a fund analyst team who interrogate the quantitative data to validate the selections.

Fund reviews

The list is updated every 6 months, in March and September. FE has a rigorous process to ensure funds are assessed regularly, including:

Every fund manager has been met by a FE analyst

Weekly monitoring using 90 different measures and funds assessed on risk, performance, behaviour and structure.

If this process identified any issues with the fund this must be fully investigated by the analyst and if necessary, it is added to a 'Watch List' for more regular monitoring. If a critical issue is identified the FE Investment Committee will make a decision about a funds removal from the list.

FE's decisions are communicated to Pannells Financial Planning Ltd (PFPL) immediately enabling any action to be taken quickly.

FE Invest Portfolios

These are risk targeted portfolios constructed using funds from the FE Invest Approved list.

FE believes that by selecting the right mix of actively managed funds to generate additional diversification enables greater risk to be taken elsewhere in a portfolio to generate additional performance.

Portfolio construction

The portfolios are targeted to a projected level of volatility based on research showing that past volatility is indicative of future volatility. This approach has been independently verified by the CASS Business School.

Actuarial firm EValue supplies a suggested asset mix for each level of volatility and this used use as a guide by FE with each FE Invest portfolio having the target of having the same or lower volatility than the suggested asset mix.

Funds are divided into core and specialist funds with the latter pursuing a narrower or niche strategy. As a result the exposure to the latter funds is limited in the lower risk portfolios.

Although funds are chosen from the FE Invest Approved list only those in the top two thirds of the list are eligible for the portfolios to attempt to minimise portfolio turnover. In addition, no more than 20% of any one portfolio can be allocated to anyone fund.

To maximise the diversification benefits of each portfolio FE uses their own optimisation technology to consider the 17 trillion different portfolios possible for each volatility target to arrive at the one predicted to deliver the maximum performance for the level of volatility.

Reviews

The FE Invest Portfolios are reviewed bi-annually in March and September by re-running the optimiser to check that the portfolios have been meeting their volatility targets and taking account of any changes in eValue's asset mixes.

Appendix 3 – ABI Mixed Investment Sectors

ABI Mixed Investment 0%-35%

Funds in this sector are required to have a range of different investments. Up to 35% of the fund can be invested in company shares (equities). At least 45% of the fund must be in fixed income investments (for example, corporate and Government bonds) and/or “cash” investments. “Cash” can include investments such as current account cash, short-term fixed income investments and certificates of deposit.

- Maximum 35% equity exposure (including convertibles)
- No minimum equity requirement
- Minimum 45% investment grade fixed income and cash
- Minimum 80% investment in established market currencies (US Dollar, Sterling & Euro) of which 40% must be Sterling
- Sterling requirement includes assets hedged back to Sterling

ABI Mixed Investment 20%-60%

Funds in this sector are required to have a range of different investments. The fund must have between 20% and 60% invested in company shares (equities). At least 30% of the fund must be in fixed income investments (for example, corporate and Government bonds) and/or “cash” investments “Cash” can include investments such as current account cash, short-term fixed income investments and certificates of deposit.

- Maximum 60% equity exposure (including convertibles)
- Minimum 20% equity exposure
- Minimum 30% fixed income and cash
- Minimum 60% investment in established market currencies (US Dollar, Sterling & Euro) of which 30% must be Sterling
- Sterling requirement includes assets hedged back to Sterling

Appendix 4 – ONS Life Expectancies Scotland

I have included details of life expectancies in Scotland below, both based on the position at birth and at age 65:-

Life Expectancy at Birth (years): by sex, Scotland, 1991-1993 to 2010-2012

Date Range	Males - Life Expectancy at Birth	Females - Life Expectancy at Birth
1991-1993	71.47	77.17
1992-1994	71.70	77.35
1993-1995	71.87	77.47
1994-1996	72.10	77.77
1995-1997	72.26	77.90
1996-1998	72.43	78.06
1997-1999	72.66	78.19
1998-2000	72.86	78.36
1999-2001	73.12	78.58
2000-2002	73.34	78.80
2001-2003	73.50	78.84
2002-2004	73.77	78.99
2003-2005	74.23	79.19
2004-2006	74.63	79.54
2005-2007	74.85	79.72
2006-2008	75.07	79.89
2007-2009	75.43	80.13
2008-2010	75.90	80.41
2009-2011	76.32	80.73
2010-2012	76.61	80.83

(Source: Office for National Statistics in July 2018)

Life Expectancy at Age 65 (years): by sex, Scotland, 2000-2002 to 2010-2012

Date Range	Males - Life Expectancy at Birth	Females - Life Expectancy at Birth
2000-2002	14.98	18.04
2001-2003	15.07	18.07
2002-2004	15.22	18.12
2003-2005	15.45	18.28
2004-2006	15.84	18.57
2005-2007	16.04	18.73
2006-2008	16.27	18.86
2007-2009	16.47	19.05
2008-2010	16.76	19.27
2009-2011	16.99	19.55
2010-2012	17.16	19.55

The Personal Injury Discount Rate – How it should be set in future
Response from the Association of British Insurers

About the ABI

The Association of British Insurers is the leading trade association for insurers and providers of long term savings. Our 250 members include most household names and specialist providers who contribute £12billion in taxes and manage investments of £1.8trillion.

Confidentiality statement

The data and other external information provided in this response is confidential to the ABI and to its members and is not to be circulated outside the Ministry of Justice, HM Treasury or the Scottish Government without the prior written consent of the ABI. In particular it should not be released if within the scope of a request for information under the Freedom of Information Act.

Irrespective of the points made above, our position is also that the information contained in this response and in the attached reports is provided to the Ministry of Justice, HM Treasury or the Scottish Government for the purpose of, and during the course of, formulating policy, such as would fall within the exemptions under the Freedom of Information Act for at least as long as it takes for policy to be implemented, not simply formulated.

Contents

Executive Summary	2-3
What should determine how the rate is set?	4-19
Relationship of the lump sum award and periodical payment orders	20-27
More than one discount rate?	28-31
Methodology for setting the discount rate	32-35
When should the rate be set?	36-39
Who should set the rate?	40-41
Periodical Payment Orders	42-46
Impact Assessment/Equalities Statement	47-49
Appendix A – The ABI's interpretation of the law as it stands	50-53
Appendix B – Examples of over compensation	54-55
Appendix C – Dual Rate	56-58

Executive summary

The ABI welcomes this speedy consultation into a long-standing challenge; how to ensure full and fair consultation for people who suffer critical, life-changing injuries. It is vital we get this right so that accident victims have the support they need to plan their futures and so that we have an insurance market that can serve them and a wider society with affordable and available insurance products.

The insurance industry wholeheartedly supports the principle of 100% compensation, where victims receive as accurate a sum as possible to reflect their future needs. It is vital this is delivered through a modern and functioning mechanism which neither under- nor over-compensates victims and which reflects the realities of the choices claimants have and choose to make.

When the Lord Chancellor set the new discount rate at minus 0.75% earlier this year, she did so on a basis that is not fit for purpose, causing untold harm to the NHS (for whom the increased burden is put at £6bn), businesses and insurance customers through the increased costs caused by an unrealistically low rate. It is critical that reform is delivered quickly if we are to avoid the worst of the ongoing impacts on consumers, businesses and taxpayers of the recent decision. Such increased costs could ultimately flow through to the pricing of UK goods and the burden on taxpayers, affecting the UK's ability to compete in a post-Brexit trading environment.

The setting of the discount rate to attempt to replicate the investment returns that a claimant will receive on their lump sum compensation over an uncertain and unpredictable future is necessarily a complex exercise and, ultimately, imprecise. For these reasons, the perfect should not be the enemy of the good. That is why our response to this consultation offers a range of analysis and suggestions to enable the Government to decide on changes to the law and permit a new rate to be set as soon as possible.

This response to the consultation sets out why urgent reform is needed and how this could be achieved, drawing on independent experts where appropriate. A new legal framework for reviewing the discount rate should be urgently set to reflect the principles and parameters which we have summarised below.

PRINCIPLES FOR THE LEGAL FRAMEWORK

The key concerns of the insurance industry is that the law for setting the discount rate achieves the following for claimants, compensators and wider society:

- Full compensation: neither under- nor over-compensation – the 100% principle
- No tie to any particular investment model – while the exercise of the legal power to set the rate will need to consider the kind of investments available and appropriate for claimants at that time, no choice should be enshrined in law, reflecting the fact that the fortunes and appropriateness of investments will vary over the years
- No tie to Investment Linked Government Securities (ILGS) –tying the discount rate to ILGS, when real life claimants instead, as advised, invest in mixed portfolios of assets which achieve a much higher return and give greater flexibility, results in over-compensation in practice and this must end
- Reflects the reality that claimants invest lump sum awards in a low-risk, mixed portfolio of assets and those who want no investment risk would choose a Periodic Payment Order (PPO)

- Includes a process of consultation with appropriate experts including economists, financial advisers and representatives for claimants and compensators in order that consideration is given to:
    - The current and future economic environment
    - Investment options and advice available to claimants and
    - How claimants actually invest their damages.

PARAMETERS FOR SETTING THE DISCOUNT RATE

This consultation response expresses the conclusion that the availability of PPOs is relevant to the framework for setting the discount rate because those wanting no risk for parts of their damages will take that option and the lump sum awards to which the discount rate applies will therefore be received by claimants with a degree of investment risk appetite. But the legal framework should not therefore more explicitly reflect the availability of PPOs.

While a legal framework which reflects the above principles and delivers a single discount rate is supported by the insurance industry, the preferred framework is one that delivers a "stepped", dual rate: that is two rates for a single case reflecting the short and longer term investment needs of claimants. This response sets out the key elements for how both single and dual rate should operate.

The timings or triggers for reviewing the discount rate will differ if there is a single or dual rate. For a single rate, review should be triggered by reference to economic markers to ensure that the single rate changes when it needs to and by incremental amounts to avoid the sudden shocks of the recent change. If a "stepped", dual rate is preferred, different triggers will need to apply to the different rates. However the rate is set in the future, the timing of reviews needs to take account of the desire for appropriate stability to allow parties to plan for long term investment and reserving requirements.

Due to the important considerations on the public purse and consumer impact, setting the discount rate should remain a decision for which there is Ministerial oversight and accountability, albeit set in a more transparent way.

What should determine how the rate is set?

Q1: Do you consider that the law on setting the discount rate is defective? If so, please give reasons.

1. Yes. This is because we do not agree with the current interpretation of the legal framework by the Lord Chancellor and which is set out in the consultation paper. The only statutory constraint on the ability of the Lord Chancellor to set the discount rate is Section 1(4) of the Act[1] which states that "before making an order under subsection (1) the Lord Chancellor shall consult the Government Actuary and the Treasury". The Lord Chancellor is constrained by the House of Lords' decision in *Wells* only to the extent that it addressed the common law framework (i.e. the 100% compensation principle and the ordinary prudent claimant investor test).

2. For clarity, our interpretation of the law as it currently stands is set out in Appendix A. As can be seen from this analysis, the Lord Chancellor is not constrained by the *Wells* decision in respect of the **application** of those general principles. Therefore in order to comply with the 100% principle and the ordinary prudent claimant test, she is not required to limit her consideration to Index Linked Government Securities (ILGS), but to decide on the appropriate vehicle in a way that is compatible with the common law principles that do constrain her.

3. However, it is evident that there are significant areas of disagreement as to the interpretation of the law as it currently stands, indeed the current Lord Chancellor has interpreted it in a different way than her predecessor, Lord Irvine, did when the rate was last set in 2001. These areas of disagreement as to how the law should be interpreted have led to the circumstances which prompted this consultation. This level of disagreement in itself suggests that the law on setting the discount rate is not working as it should, and results in a lack of clarity for all stakeholders.

4. The Ministry of Justice (MoJ) quite properly adopts the 100% compensation principle as the fundamental principle within this consultation and in the setting of the discount rate. A failure to account for how claimants are advised to (and do in practice) invest their damages in reality rather than in theory means that the current MoJ interpretation of the law leads to a significant departure from this key principle, in that claimants will inevitably be over-compensated by a rate set with reference to ILGS since, in reality, they invest in a mixed portfolio of assets which achieve much higher returns.

5. As set out below, the adherence to ILGS alone as a single investment has created a situation whereby it is assumed an ordinary prudent claimant would invest in a vehicle that produces negative real returns, something that no properly advised claimant would do. Furthermore, a claimant who does not invest in this way is very likely to be over-compensated for their loss based on the current discount rate of minus 0.75%. To our knowledge no claimant currently invests solely in ILGS nor would they be advised to do

[1] Damages Act 1996

so: the remaining sections of this response build on these points with evidence from leading experts involved in this field.

6. As a result, the law must be re-visited in order to clarify the position, so that the common law framework, particularly the 100% compensation principle, is not undermined when the rate is reviewed in future. In re-visiting the law it would be advisable to specify relevant considerations for the relevant decision maker to take into account: this should include, for example, taking account of how claimants invest their awards in practice to ensure that an appropriate investment model is considered.

Q2: Please provide evidence as to how the application of the discount rate creates under- or over-compensation and the reasons it does so.

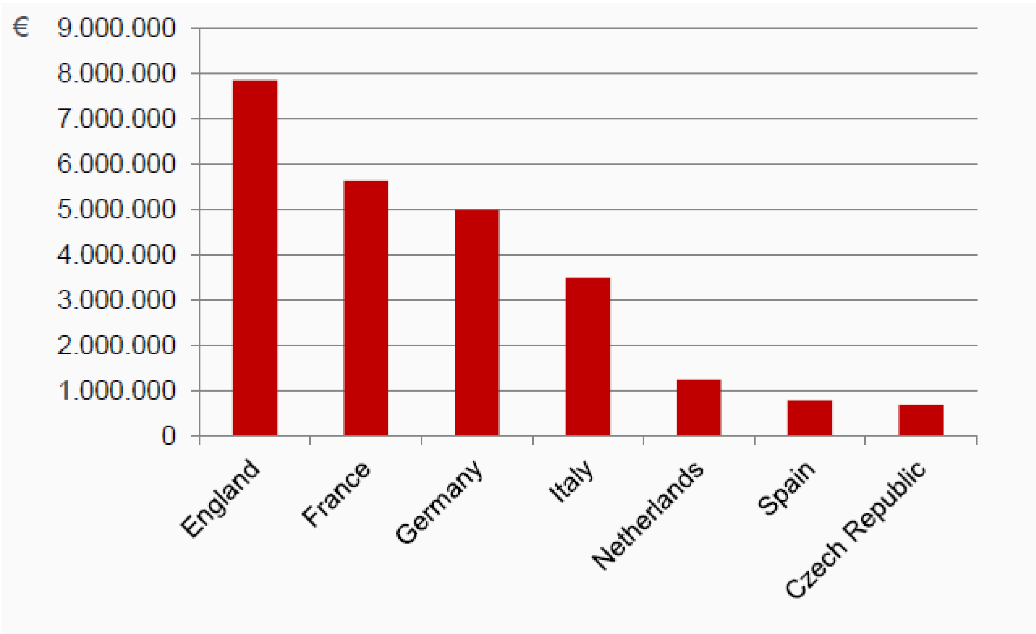
7. The search for a 'precise' level of compensation is always going to be artificial in that the calculation of damages is made against a set of unknown variables. Mortality risk can only ever be indicative, as are the claimant's predicted future needs. However, it is necessary for the parties to agree or for the court to decide, as best it can, based on the information available, what sums will adequately compensate the claimant for their losses over their life expectancy.

8. Once the total losses are calculated, then a discount rate is applied to account for the accelerated receipt of those funds. A discount rate that is too high, i.e. at a level where the claimant cannot achieve the appropriate returns, will lead to under-compensation for the claimant as their fund will not be able to keep up with inflation and will not meet their assessed needs for the full duration. Conversely, a discount rate that is too low means that the claimant is over-compensated as they will be achieving much higher returns than the discount rate allows for.

9. <u>The current discount rate of minus 0.75% will inevitably lead to over-compensation as no properly advised claimant would ever invest in ILGS alone and it does not reflect the investment returns that cautious claimants achieve when investing their damages in reality.</u> This is compounded by the long investment time frame (often 40-50 years) as a negative real return is assumed not just for year one, but for each year for decades to come.

10. Exhibit 1 below is a table compiled by Munich Re (prepared before the discount rate was reduced) which gives a comparative indication of the level of damages awarded in the UK as against a number of other jurisdictions in Europe. It is clear that awards in the UK are far higher than in these European counterparts, a difference that has been greatly increased by the reduction in the discount rate. The example is based on a 30 year old male with a severe brain injury, permanent disability, married with no children and an annual net income of 60,000 euro. The figures are indicative only:

Exhibit 1: Munich Re, average bodily injury compensation amounts in Europe



11. Over-compensation becomes most apparent in cases where there are long periods of loss of earnings or care claimed. This is because of compounding returns (a 1% variation in return makes a limited difference over one year but a very large difference over 50 years). Enclosed at Appendix B are some tables that give worked examples of how over-compensation can be created by a discount rate that does not appropriately reflect the rate of return that can be achieved.

12. The first example is that of a male who is 25 years old at the date of settlement and will never work again following a road traffic accident. He has a degree and it is determined that he would have earned £50,000 a year until retirement at age 65. His cost of care will be £30,000 per year for the rest of his life.

13. Applying the current discount rate of minus 0.75%, his total lump sum damages for future losses will be **£4,502,895.**

14. If in this example we assume that the claimant invests in a low-risk, mixed asset portfolio and achieves a significantly better return than the minus 0.75% allowed for by the current discount rate, then he will have been over-compensated for his losses. If he were to achieve a 2% return in real terms, he would be able to fund annual costs of just over £152,000. That represents £72,000 over-compensation relative to the £80,000 actually awarded.

15. Had a 2% discount rate been applied in calculating the award, the total lump sum for his future losses would therefore have been £2,300,070. The total lump sum over-compensation in this example is **£2,202,825**.

16. One of the key factors in this example of a typical severe injury claim is the life expectancy of the claimant: if unimpaired by his injury, this would be for 63.2 years from

anticipated settlement. Over that period of time, a discount rate based on a comparatively short-term view of likely returns from investment will almost inevitably be too cautious, resulting in significant over-compensation.

Q3. Please provide evidence as to how during settlement negotiations claimants are advised to invest lump sum awards of damages and the reasons for doing so.

17. As highlighted in our response to the 2013 consultation[2] (Annex G) *"Claimants have both specialist legal and independent financial advice and will take decisions as to their future having fully considered that advice and usually in conjunction with their medical experts, carers and family."*

18. Insurers do not have access to the specialist financial advice that claimants receive during the negotiation process as this is private advice between the claimant and their advisers. However, the vast majority of catastrophically injured claimants, i.e. those for whom the form of award is a consideration, will be advised by an independent financial adviser (IFA) on the form of the damages that is best for them. On occasion, the IFA may attend joint settlement meetings, although they will be in a separate "claimant room" rather than sitting in on the negotiation; or they may be available on the end of a telephone to discuss the options for the form of award. Attached at Annex D is a paper comprising comments prepared by John Frenkel, a forensic accountant and founder of claimant IFA firm Frenkel Topping, who notes that the fact that claimants receive financial advice during the settlement negotiation "is really taken for granted these days".

19. In their report for the Ministry of Justice in 2013[3] Ipsos Mori states as follows:

> *"Most claimants reported that they had been advised on the advantages and disadvantages of both (PPOs and lump sum) by their solicitor, and also, in some cases, by a financial advisor who had been involved in the case through the claimant solicitor. As an example, one participant reported that a financial advisor had presented a report to him on the advantages of PPOs versus lump sums, which he had reviewed before making his decision. Again, he felt that this had been quite difficult to understand, which could explain why claimants tended to report that they adhered to the advice of solicitors on this matter."*

20. Claimant representatives will be in a position to provide a more detailed response as to the general nature of the advice received.

[2] Damages Act 1996: The Discount Rate Review of the Legal Framework CP 3/2013
[3] Personal Injury Discount Rate Research, Ministry of Justice Analytical Series 2013

Q4: Please provide evidence of how claimants actually invest their compensation and their reasons for doing so.

21. When an insurer settles a claim by lump sum payment, in accordance with the "clean break" principle, they do not have an ongoing relationship with the claimant. As such, in order to answer a question on how claimants invest, we have engaged with relevant leading wealth managers and investment strategists who manage money for claimants. Advice and evidence has been sought from the following:
    - Mark Quilter is a chartered wealth manager with Charles Stanley & Co and has prepared their report. He has worked as an investment manager advising claimants on the investment of their personal injury awards and managing the investment of those awards since 1987. Full details of his qualifications and experience are detailed in the Charles Stanley report at Annex A.
    - Pannells Financial Planning Ltd (Pannells) are independent financial advisers regulated by the FCA and established in 1989. They deliver specialised financial advice to companies, professional partnerships and individuals and have considerable experience of advising individuals on suitable investment structures. Full details of the company are detailed in their report at Annex B.
    - Simon Carling is the Managing Director and major shareholder at MVA Holdings Ltd (McGarrie Vahey & Partners) and has prepared their report. He has worked with personal injury clients since 1999. Full details of his qualifications and experience are detailed in the MVA report report at Annex C.

22. Their reports identify a number of important facts:
    - like any other prudent investor, personal injury claimants are strongly advised not to place their compensation solely in one type of investment;
    - over the last few years personal injury claimants have stopped investing in ILGS at all, which are, for reasons we discuss in our answer to Question 5 below, no longer a suitable investment vehicle for claimants;
    - claimants are advised to invest in diversified lower risk portfolios reflecting their inability to make up capital elsewhere;
    - there is no such thing as a risk-free investment, contrary to any suggestion from the MoJ's expert panel that such a concept exists, whether in theory or practice;
    - investors purchasing ILGS on the secondary market face a guaranteed loss if held to maturity; and
    - any change in the discount rate would not mean a change in investment strategy.

23. It is clear there are a range of factors which will determine a claimant's investment approach; further comments are set out in John Frenkel's report at Annex D. These factors will be specific to individual claimants, for example cash flow planning, life expectancy and wider financial circumstances.

Typical asset allocation for claimants

24. Charles Stanley's report, attached at Annex A, sets out the range of asset allocation currently adopted and how that has changed since our response to the Government's 2012 consultation (Annex F) which also incorporated a report from them.

25. As Exhibit 2 below demonstrates, very few claimants invest 100% in cash investments, by which Charles Stanley mean investment that is limited to Government Gilts (including ILGS where appropriate historically, although not used now) along with fixed interest securities and cash deposit. Of the 303 clients whose awards Charles Stanley are currently managing, only 2 (0.7%) are noted to be investing in this way. The remaining 301 (99.3%) invest in mixed portfolios based on different indices in accordance with either the financial need or risk appetite. In order to decide on a suitable investment strategy, Charles Stanley first consider financial need, minimum level of risk and then adopt the level of risk that the client decides they want to assume (see paragraph 4.1 of their report).

Exhibit 2: Breakdown of claimants managed by Charles Stanley

Number of PI Awards managed by Charles Stanley as at March 2017				
	Asset Allocation	Level of Risk	Clients	
			as at Sept 2012	as at March 2017
CO1	100% Cash Investment	Lower	12	2
CO2	PI Conservative Index	Lower	69	88
CO3	PI Income Index	Medium/Low	72	107
CO4	PI Balanced Index	Medium/Low	116	106

26. Pannells' report, attached at Annex B, sets out the consultation they have carried out with Investec, LGT Vestra and Cazenove to understand the type of portfolios they would construct for claimants with a low risk appetite. The breakdown of their recommendations can be seen from page 11 of their report. Each of their recommendations allows for a wide asset mix in order to minimise risk:

- Investec advises that, in broad terms, for a low risk investor seeking a return from a combination of income and growth, the following asset mix would be considered: Fixed interest (UK Gilts, ILGS, Global Government Bonds, Investment Grade Corporate Bonds, High Yield Bonds and Emerging Markets) 55%; Equities (UK Equities and Equities Global Developed Markets) 16%; Property 8%, Alternative Investments 11%; Cash 10%.
- LGT Vestra provides portfolios in its Managed Portfolio Service range. The asset allocations are used by its investment managers as a basis for bespoke portfolios. The Defensive and Cautious portfolios, outlined below in exhibit 3, could be considered suitable for a low risk investor seeking a return from a combination of income and growth. The respective asset mixes as at March 2017 were as follows:

Exhibit 3: LGT Vestra defensive and cautious portfolio mix

Asset Class	Defensive Weighting	Defensive Weighting		Cautious Weighting	Cautious Weighting
Fixed Interest:-					
- UK Gilts	0.0%			0.0%	
- ILGS	6.0%			4.0%	
- Global Govt Bonds	5.0%			5.0%	
- Investment Grade Corporate Bonds	13.0%			13.0%	
- High Yield Bonds and Emerging Markets	6.0%			4.0%	
		30.0%			**26.0%**
Equities:-					
- UK Equities	13.0%			19.0%	
- Equities Global Developed Markets	12.0%			15.0%	
		25.0%			**34.0%**
Property/Infrastructure		0.0%			3.0%
Alternative Investments		40.0%			32.0%
Cash		5.0%			5.0%
Total		**100.0%**			**100.0%**

- Cazenove offers four portfolios for private clients, namely the Cautious, Balanced, Growth and Aggressive portfolios. Each investment manager will be guided by the asset allocation within these portfolios, having established which is suitable for the client. For a low risk client seeking a return from a combination of income and growth, the Cautious portfolio is likely to be considered. In broad terms, Cazenove would currently suggest the following asset mix, outlined below in exhibit 4, if investing for a Court of Protection client:

Exhibit 4: Cazenove cautious clients

Asset Class	Weighting	Weighting
Fixed Interest:-		
- ILGS	18.0%	
- Global Corporate Bonds	11.0%	
- Investment Grade Corporate Bonds	16.0%	
		45.0%
Equities:-		
- UK Equities	14.0%	
- Global Developed Markets	9.0%	
		23.0%
Property/Infrastructure		5.0%
Alternative Investments		24.0%
Cash		3.0%
Total		**100.0%**

27. MVA's report, attached at Annex C, advises that a typical personal injury portfolio in 2017 would include:
    - Any Periodical Payment Orders (PPOs) in place
    - 30% Fixed Interest
    - 13% UK Equities
    - 12% Overseas Equities

- 40% Absolute Return / Alternatives
- 5% Cash
- 0% Infrastructure

28. The experts' reports all recognise that, in general, personal injury claimants are different from the ordinary prudent investor, but that properly advised, claimants ought to (and do) adopt an investment strategy which focuses on a low risk profile. This puts the ordinary prudent claimant investor (as identified by the House of Lords in Wells v Wells) in a real world and up to date context.

29. The real world context differs in important ways from the theoretical model relied on by the expert report obtained by the MoJ as part of its last review of the discount rate. What is clear from the ABI's experts' reports is that the appropriate investment model for claimants has been fluid over time and will adapt to market conditions as necessary to achieve the appropriate returns.

30. While, in theory, it is possible that investing solely in ILGS was the right measure in 1998, there is a consensus from financial experts that no investor, let alone a catastrophically injured claimant, should ever invest in a single asset class. Even by 2001 the then Lord Chancellor recognised that the return on ILGS was not the only measure he should consider and that claimants did not invest solely in ILGS in practice[4]. By 2017, as the experts' reports demonstrate, it is neither the right measure nor an approach any reasonable claimant would adopt. John Frenkel in his report at Annex D goes so far as to state "*It is highly unlikely that any IFA has ever recommended a PI claimant to invest any of their money in ILGS let alone 100%.....It would potentially be negligent for any IFA to advise any investor to invest all of their money in any one particular investment vehicle*."

Q5: Are claimants or other investors routinely advised to invest 100% of their capital in ILGS or any other asset class? Please explain your answer. What risks would this strategy involve and could these be addressed by pursuing a more diverse investment strategy?

31. The experts' reports clearly demonstrate that claimants would not be advised to invest solely in ILGS, indeed they would not be advised to invest solely in any asset class. There is a clear theme in the reports that diversification is essential in order to minimise the risk of investment.

The use of ILGS as part of a mixed portfolio

32. The general picture is that since *Wells v Wells* in 1998 and since the discount rate last changed in 2001, claimants have been advised to invest in lower risk mixed portfolios and that remains the advice today. These portfolios may contain a proportion of ILGS and other fixed interest instruments, a proportion of "cash" and most significantly, a proportion of UK and world equities.

[4] Discount rate: statement laid by Lord Irvine of Lairg in the libraries of both Houses of Parliament on 27 July 2001

33. Claimants who received awards following *Wells v Wells* tended initially to invest a large proportion of their awards in cash investments (usually bank deposit accounts). This was especially so as the Special Account at the Court Funds Office was generally returning 2% above base rate and the capital was underwritten by the Bank of England. The cash weighting for these clients would generally range from 100% to 50% and the remaining proportion was invested in equities.

34. MVA's report highlights (see Annex C page 4), that in 2001 returns on 10 year ILGS would have been circa 2.6% compared to minus 2.2% today. Therefore investors were able to obtain "real" (i.e. net of inflation) annual gains over 10 years of 4.4%. This is one of the main reasons why ILGS potentially made up a large proportion of a personal injury award portfolio or was assumed to do so at that time.

35. In their report (see Annex A at pages 3-5), Charles Stanley outline the history of their clients' use of ILGS as an investment vehicle, why they were advised to do so and why that has since changed. In summary by 2009, ILGS were used as a means of providing returns ahead of the Special Account rate of 0.5%. Investment in ILGS was always made with a view to holding them to within 6 to 12 months of redemption and selling at that point to avoid capital erosion. They were not a long term investment.

36. Charles Stanley's approach towards investing in ILGS quickly evolved because price movements provided an opportunity to trade them within the market place and achieve enhanced returns. This trading opportunity arose when the price of ILGS stood at sizeable premiums relative to their anticipated redemption values. The dividends on ILGS were higher at that time than they are now which helped to make them a more attractive investment.

The problem with investing in ILGS

37. Charles Stanley advise that this was always a short term strategy and between May 2013 and August 2016, the investment in ILGS continued but in a far more selective and cautious manner. ILGS holdings made up a progressively smaller proportion of the cash weighting, as the stocks purchased before May 2013 were gradually sold before maturity to prevent capital erosion prior to redemption. Following the base rate cut in August 2016 when the rate was reduced to 0.25%, ILGS looked even less attractive as an option and Charles Stanley disposed of their remaining holdings.

38. Due to claimants' need for certainty, Charles Stanley advise that their clients only ever bought relatively short dated ILGS. As of the end of March 2017, the two shortest-dated ILGS (2017 and 2019) have negative nominal yields at an average of -0.90%, while the remaining two (2020 and 2022) have an average positive nominal yield of +0.32%. This means that ILGS are no longer a viable choice for individual investors when taking inflation into account. In Charles Stanley's recent experience, the cash weighting of client portfolios has been invested in external fixed interest funds which do include some bonds but no ILGS.

39. According to Pannells' report at Annex B, in practice there are a number of problems that mean ILGS cannot be considered a risk free investment. In particular, since 2012 there has been a significant increase in the risk of holding this asset class, in that the value of ILGS can fluctuate significantly, both in the short-term and longer-term, which could result in a capital loss. Due to the increase in the prices of ILGS, investors purchasing ILGS on the secondary market (which is the only way individual investors can purchase ILGS) face a guaranteed loss if held to maturity. It is important to note that real yields on ILGS can and do change; they can be volatile just as the yields of conventional bonds are volatile. Real yields are influenced by many factors, including fiscal and monetary policy, supply and demand, liquidity and the level of economic growth.

40. This is confirmed by Oxford Economics' report at Annex E which states in section 4.1 "*Depending on the scale of the inflation related capital uplift at the time of redemption, this may mean a capital loss on the investment in nominal terms if it is held to redemption – it almost certainly means a capital loss in real terms.*"

41. ILGS have exhibited far greater volatility compared to the mixed investment portfolios that could be considered for a cautious investor. Indeed over the last three years volatility has been greater than the FTSE 100.

Importance of investment diversification

42. Under normal market conditions, diversification is an effective way to reduce risk. If an investor holds just one asset class and it performs badly, they could lose all of their money. If holding a diversified portfolio with a variety of different investments, it is much less likely that all of the investments will perform badly at the same time. While it cannot guarantee against losses, diversifying a portfolio effectively – holding a blend of assets to help navigate the volatility of markets – is vital to achieving a client's long-term financial goals whilst minimising risk.

43. It is possible to partially diversify within one asset class – for instance, by holding a portfolio of corporate bonds and government bonds. These stocks can offer very different propositions, with the former tending to offer higher possible returns but with a higher risk of defaults, or bond repayments not being met by the issuer. However, this will also fail to insulate an investor from systemic risks, such as a rise in interest rates.

Q6: Are there cases where PPOs are not and could not be made available? Are there cases where a PPO could be available but a PPO is offered and refused or sought and refused? Please provide evidence of the reasons for this and the cases where this occurs.

44. It is important to note that even where a PPO is awarded, the claimant will usually have both a lump sum for some future losses (calculated by reference to the discount rate) and a PPO. A PPO usually, but not always, covers only the future care elements of the claim. Sometimes a claimant will seek future loss of earnings as part of the PPO

settlement, but this is rare with most claimants preferring the future loss of earnings to form part of the lump sum award.

45. The form of the award is very much a decision for the claimant to make in consultation with their legal and financial advisers. If the claimant wants a PPO, it is very unlikely that a Court would refuse to award it, subject to the criteria that the Court must take into account as to the security of the payment. Sections 2(3) and 2(4) of the Damages Act 1996 state as follows:

(3) A court may not make an order for periodical payments unless satisfied that the continuity of payment under the order is reasonably secure.
(4) For the purpose of subsection (3) the continuity of payment under an order is reasonably secure if–
(a) it is protected by a guarantee given under section 6 of or the Schedule to this Act,
(b) it is protected by a scheme under section 213 of the Financial Services and Markets Act 2000 (compensation) (whether or not as modified by section 4 of this Act), or
(c) the source of payment is a government or health service body.

46. The vast majority of insurers will be able to comply with the requirements for secure payment by virtue of (4)(b), (save for the issue as to limits of indemnity explained further below) but that is not the case for all compensators. Any unsecured motor insurers are however backed by the MIB so a PPO would always be available in any motor claim.

<u>Employers' liability and Public liability claims</u>

47. Indemnity limits for cover will usually be found in employers' liability policies (where a statutory minimum level of cover for personal injuries at £5 million is in place[5]) and in public liability policies (where there is no statutory minimum level of cover for personal injury). Motor policies are required by law to provide unlimited cover for personal injuries.

48. In an employers' liability claim with a policy limit of indemnity, there may be a risk that the level of indemnity under the policy might be exceeded by the total payments anticipated under a PPO. This is also the case for Public Liability claims and is more likely to be an issue for sole trader/small business policies where the level of indemnity is likely to be less than £5 million.

49. In both instances, the risk of shortfall may also apply to the level of any lump sum award, especially where the defendant is otherwise of limited funds. This has obviously been exacerbated by the decrease in the discount rate, with more claims now likely to exceed policy limits that were agreed before the reduction. As a result, insurers will need to consider increasing levels of indemnity for future policies, with the associated costs to the consumer of doing so.

[5] Employers' Liability (Compulsory Insurance) Act 1969

Contributory negligence

50. An offer of a PPO might be unacceptable in a case where there is a significant deduction for contributory negligence, as it might be considered that the annual amount of the PPO would be insufficient to cover the actual cost of care on an ongoing basis. It should be noted that the existence of the deduction does not always preclude the agreement of a PPO, but in general claimants prefer lump sum awards in such cases.

51. A PPO might also, in some cases, be considered unacceptable by both sides in cases where the annual sum involved is relatively small or where the life expectancy is relatively short. In such cases a PPO might not be offered or requested because of these factors. Ultimately the control provided by the court's discretion, subject to the question of security under section 2 of the Act, is considered adequate.

PPOs in Scotland

52. The position regarding PPOs is different in Scotland where both parties must agree to a PPO. The courts have no power to impose such an order on any unwilling party. In December 2013, the Scottish government indicated its intention to change the law to allow the courts to award a PPO even where the parties did not both agree.[6] This intended change was not enacted. The law in Scotland should be amended to give the courts this power to bring them in line with the rest of the UK and allow those claimants who choose to do so to secure an income stream for life.

Q7: Please provide evidence as to the reasons why claimants choose either a lump sum or a PPO, including where both a lump sum and a PPO are included in a settlement.

53. Compensators are not party to either the financial advice that a claimant has or to the detail of what the claimant intends to do with their damages. There are many factors that will have a material impact on whether a claimant decides to take a PPO as a settlement.

54. Only claimants and their legal and financial advisers can provide evidence of the reasons why claimants choose to settle their claim on a PPO basis. However, it appears that claimants take into account a number of factors when deciding what form of award to choose and that some of those factors are not financial. Those factors, and the weight given to them by the claimant, will vary from case to case depending on the circumstances of the individual claimant and their attitude or wishes.

55. The most obvious factor is the desire of the claimant to protect the interests of their family/dependents in the event that the claimant dies earlier than their predicted life expectancy. For people who have suffered a traumatic injury and worry about their family's financial future this legacy provision for the family is often a compelling reason for choosing investments for their lump sum rather than a PPO which ends with their death. For most claimants, it is likely that control over their money and receipt of the lump sum overrides any fears that the money will run out. Whilst the idea of leaving a legacy

[6] Civil Law of Damages: Issues in Personal Injury http://www.gov.scot/Publications/2013/12/7197

for the claimant's family runs contrary to the principle of full compensation, the principle that choice should be the key factor is supported.

56. The non-financial factors can include the desire to cut all links with the defendant or the compensator. The financial factors can also include the desire to make the most of the investment opportunities, to have the ability to spend their damages on what they want, when they want, or, as noted above, simply to be in a position to leave a legacy to their family when they pass away. These factors are considered in the Ipsos Mori report[7]:

> "Overall, the lump sum was seen as an independent income which would allow claimants to provide for their family in the future or retain the independence they had before their accident. This countered many of the risk factors for a lump sum, or the advantages of a PPO for those who would have been eligible for them.
>
> > *A lump sum is more risky, but it draws a line under it, you've got your money and you spend it how you want … it provides a contingency for family in case something happens to you: at that stage [settlement of the case] you're quite unhealthy in your mind and I didn't want to take the risk that my family wouldn't get anything. In my mind, if I went for a PPO and I died, my family would suffer, and they'd been through the trauma too.*
>
> Claimant with spinal injuries, RTA, settled post-2005

*A few claimants also felt that the lump sum offered a point of **emotional closure for a stressful and difficult period** and was a more appropriate and empowering type of settlement because it gave the claimant/ carer freedom to spend the money as they chose. This view was expressed by parents/ carers of claimants who were children as well as adult claimants.*

> *I didn't want to feel my whole life was controlled by this process – like I'm 10, when I'm an independent career person. Maybe [a PPO] is good for someone who is 14, but I would feel like the compensation isn't really mine. You're not free, it's keeping you in the same place.*
>
> Claimant with multiple injuries and post-traumatic stress, RTA, settled post-2005

<u>*Roberts v Johnstone*</u>

57. As noted above, the reasons why claimants prefer a lump sum award may be complex and are not always financial. One of the complicating factors in some cases is around how claims for the cost of alternative accommodation are calculated. In *Roberts v Johnstone* [1989] QB 878[8] the courts stated that:

> *"the object of the calculation is to avoid leaving in the hands of the plaintiff's estate a capital asset not eroded by the passage of time; damages in such cases are notionally intended to be such as will exhaust the fund contemporaneously with the termination of the plaintiff's life expectancy."*

[7] Section 5.4

[8] Stocker J at p893

58. The calculation required involves applying the discount rate to the notional capital cost to create an annualised cost, to which the life multiplier is then applied. This approach was approved by the House of Lords in *Wells v Wells* as an "elegant solution"[9]. In practice, even before the change in the discount rate to -0.75%, this approach (whilst correct in law) would not generate the capital needed to fund the actual purchase of the property. This in turn could affect the willingness of the claimant to opt for a PPO for all or some elements of future loss.

59. That does not of itself mean that the *Roberts v Johnstone* approach is wrong. In applying the concept that the claimant should not be left with a capital asset in their hands at the end of their life, the courts have followed the conventional approach to the award of damages and to the 100% compensation principle.

60. The change in the discount rate in March 2017 to -0.75% has created a further problem with the *Roberts v Johnstone* calculation in practice. The current law would now require the claimant to calculate the notional annualised cost using the negative discount rate, which means the annualised cost would have to be a negative number to avoid over-compensation. In effect, a claim for the cost of purchasing alternative accommodation would become a credit to be given against other heads of damage rather than a future loss. It is our understanding that as a result some claimants are already saying they will abandon any claim for this head of damage, whilst others are arguing (contrary to the current law) for a different rate to be applied.

61. As highlighted above, the problems created by the reduction in the discount rate do not mean the *Roberts v Johnstone* approach is wrong. Rather they demonstrate the folly of setting the discount rate at an artificially low level which does not reflect the approach of claimants to future loss in practice. In our view *Roberts v Johnstone*, as approved in *Wells v Wells*, remains not only good law but the right approach to the application of the 100% compensation principle.

Q8: How has the number of PPOs changed over time? What has driven this? What types of claims are most likely to settle via a PPO?

62. Our response to the 2013 consultation noted as follows:

Despite the availability of PPOs the vast majority of claimants still opt for a lump sum settlement. The graphs below (which represent more than 94% of the FSA Regulated market and exclude the MIB) reproduced with the permission of the General Insurance Research Organising Committee (GIRO) Working Party and taken from the September 2012 update "Juggling Uncertainty – The Actuary's Part to Play", indicate that around 15% of EL/PL claims with awards of over £1 million and around 30% of motor claims with awards of over £1 million settle on a PPO basis.

[9] Lord Lloyd 380B

Exhibit 5: Motor PPO propensity, IFoA PPO Working Party

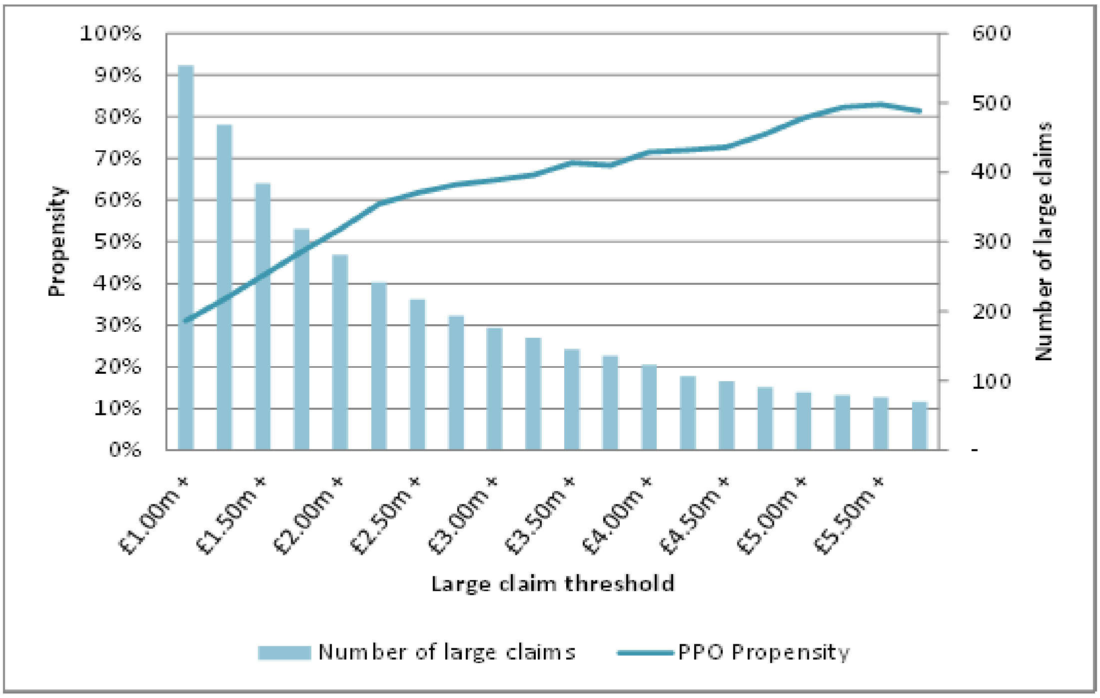
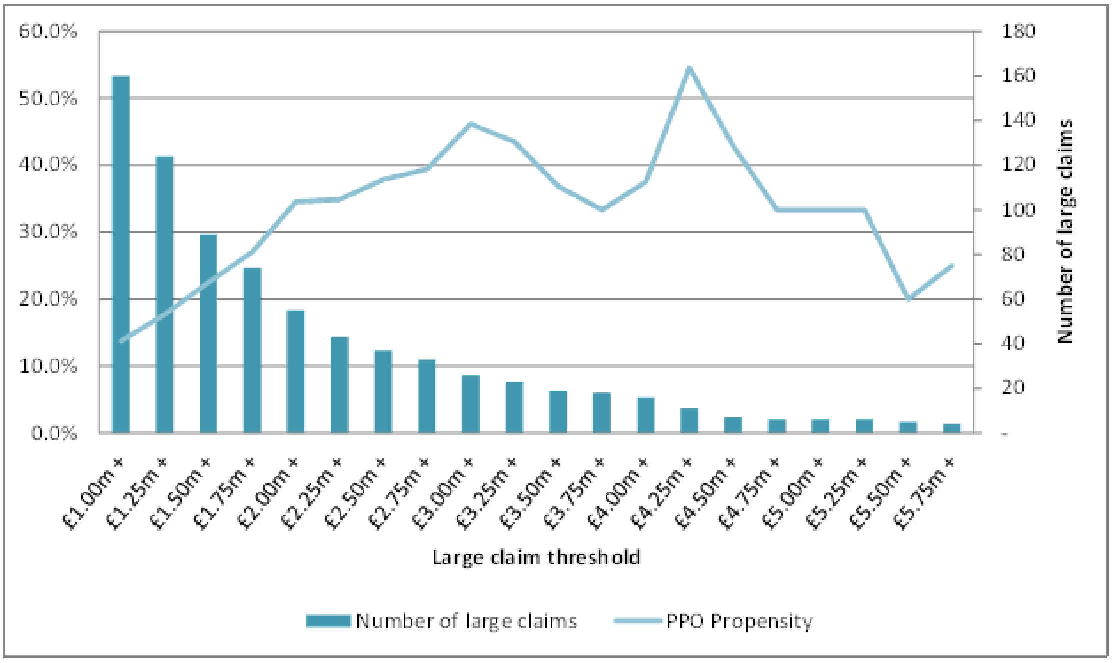
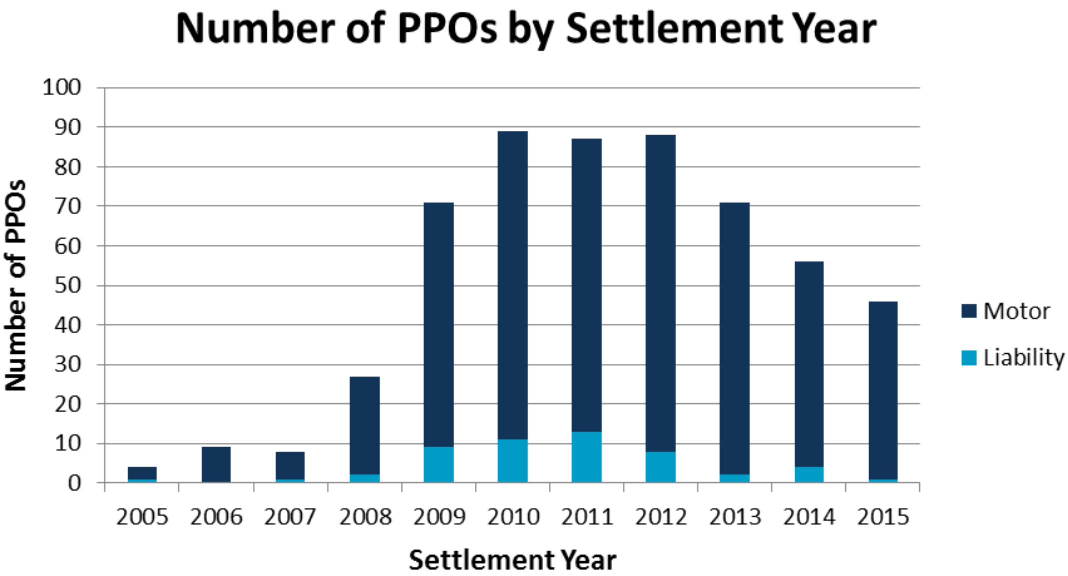


Exhibit 6: Liability, PPO propensity, IFoA PPO Working Party



63. In their 2016 update report, the GIRO Working Party notes that the number of PPOs by settlement year has been falling steadily since 2012.

Exhibit 7: Number of PPOs by settlement year, IFoA PPO Working Party



64. It is not clear why the number of PPOs has fallen in recent years, although the fact that their use increased in 2009 and tailed off after 2012 could be linked to the financial crisis. As noted previously, the use of PPOs is driven by claimant choice and they will decide, based on financial and legal advice, whether they would prefer to have a lump sum or a PPO. However, the correlation in the graph between the propensity for PPOs and turbulent investment markets would also suggest that claimants are influenced by the external environment and how safe it is to invest their damages, as claimant choices are driven by longer term views of potential returns.

Types of claims most likely to settle via a PPO

65. Whilst this does not make it clear why propensity is falling, there are some cases which are far more suited to PPOs than others. Any case where there is potentially a very long period of loss (for example cases involving injury to young children) and any cases where life expectancy is either disputed or very uncertain, a PPO is more likely to be sought by the claimant or on the claimant’s behalf. The benefit to claimants in doing so is that longevity risk then transfers to the compensator and the prospect of a claimant’s lump sum settlement award being exhausted is reduced.

<u>Relationship of the lump sum award and periodical payment orders</u>

Q9: Do claimants receive investment advice about lump sums, PPOs and combinations of the two? If so, is the advice adequate? If not, how do you think the situation could be improved? Please provide evidence in support of your views.

66. It is clear from the Ipsos Mori report, and from insurers' experiences during joint settlement meetings, that claimants do obtain financial advice before settlement about the structure of the settlement, how much should be a lump sum and how much should be a PPO (if any). The reasonable cost of this advice is recoverable from compensators by way of a claim for disbursements and this cost is frequently claimed.

67. Section 6 of the Ipsos Mori report covers the nature of the advice that claimants take after the award of their damages. Clearly, even in that very small sample, the advice will differ. Much will depend on the size of the award, the nature of the claimant's injury and the claimant's own experience of handling their own investments prior to the accident. Ipsos Mori at page 39, reports a very positive experience from those claimants who engaged with an IFA:

> "In this study, those who had used a financial advisor tended to be very pleased with the services and support they received. Even those claimants who were confident with their finances felt that **specialist investment advisors were invaluable** in ensuring that their long-term needs were met.
>
> *No matter how confident I am with managing money I'm not an investment expert. You have to be confident to trust them to invest money based on knowing what my needs are going to be.*
> Claimant with spinal injuries, RTA
>
> Advisors were typically **highly trusted by claimants,** and the advisors themselves reported being in contact with claimants and their families for many years, providing advice and support throughout.
>
> *We're 'financial social workers' … we become like family.*
> Financial advisor"

Q10: Do you consider that the present law on how the discount rate is set should be changed? If so, please say how and give reasons.

68. As stated in response to question one, the current lack of clarity over how the law should be interpreted means that it is essential that there should be a change.

69. The law must be changed so that it provides stability and certainty to all parties and enables a functional compensation system to operate alongside a well-operating insurance market. To achieve this, the law should clearly allow the decision maker to take a far more broad brush approach to the setting of the discount rate than a narrow focus on ILGS. As stated in our 2012 consultation response:

However we believe that this question, like others in the consultation paper, betrays a quest for a degree of precision which is artificial and inappropriate. The Lord Chancellor should adopt a broad brush approach, such that no one mix of assets should be used as the basis for setting the rate.

70. As demonstrated below, the reality is that claimants are low risk (not very low risk) investors, and certainly not "no risk" investors, as currently assumed by the Lord Chancellor. Once a policy decision is taken on the level of investment risk appropriate for a claimant taking a lump sum, then the law should be set to allow for a wide range of factors to determine the type of investments that are made by a low risk investor. As outlined above, the advice from the experts is that investment strategy inevitably changes over time: a broad brush approach should allow for sufficient flexibility and not rigidly adhere to one investment model, which may prove to be inappropriate in future to reflect the reality for ordinary prudent claimant investors.

71. The response to question 15 sets out the two options that the government should be considering: a single rate or moving to a dual "stepped rate". How the law should be changed in future will be guided by which of these options the government considers to offer the most appropriate outcome as against the outlined principles.

Q11: If you think the law should be changed, do you agree with the suggested principles for setting the rate and that they will lead to full compensation (not under or over compensation)? Please give reasons.

72. The consultation paper sets out proposed general principles for setting the rate as follows:

The discount rate should be the rate that in the reasonable opinion of the setter is (a) consistent with the returns expected from the investment strategy implied by the appropriate risk profile of the claimant (see below) and (b) satisfies the following:

- *the lump sum payable after the application of the discount rate plus the assumed income expected to be earned should represent the full loss, neither more nor less, caused by the wrongful injury;*
- *the losses and costs assessed by the court to flow from the injury should be met on time; and*
- *the capital and the income assumed to be earned from the award must be exhausted at the end of the period for which the award is made.*
- *Due regard should be given for the following factors:*
  actual returns that claimants are likely to receive on investments; and availability of a PPO in respect of some or all of the loss.

73. As high level principles for the setting of the rate, the proposals are appropriate. However, there is a risk that these principles lead to a quest for a "precise" discount rate for each individual claim. Any approach which seeks to set the discount rate on a case

by case basis would lead to too much dispute and uncertainty. The Statement of Reasons issued by Lord Irvine in 2001[10] makes the strong case for a uniform approach.

74. In order to address some of these challenges, the principles should also include the following points:

- full compensation: neither under- nor over-compensation
- no tie to any particular investment model or index, in particular any tie to ILGS is inappropriate and at best outdated
- allow for the reality that claimants invest in a low-risk, mixed portfolio and recognise that a claimant with no appetite for investment risk, as opposed to a 'low risk' appetite, has the option to choose a PPO for some future losses
- include a process of consultation with economists, financial advisers and representatives for claimants and defendants
- the framework needs to include consideration of relevant factors:
  - the current and future economic environment
  - investment options and advice available to claimants
  - how claimants actually invest their damages

75. Any system should clearly allow for an investment approach where the losses and costs can be met on time. <u>The investment in a mixed portfolio will achieve this end in a way that ILGS cannot</u>. The inflexibility of ILGS and inability to meet a claimant's needs from investment solely in ILGS is one of the fundamental problems with investment in that asset class. A mixed portfolio allows far greater fluidity for the claimant and will ensure that the capital is available when it is required.

76. The capital sum and income should be exhausted at the end of the period for which the award is made. If the damages are not calculated on the basis of that assumption then it is likely that the claimant has been over-compensated against their losses, which would be directly at odds with the principle of full compensation. Although claimants interviewed in the Ipsos Mori poll understandably talked about leaving a legacy for their family, that is not a relevant consideration in how a claim is valued (this point is particularly important when considering the issue of how claims for the cost of accommodation are to be treated, see response to question 7). To achieve an outcome whereby both the capital sum and income are exhausted, account must be taken of <u>total</u> returns (both capital **and** income), not just income **or** capital returns, see Charles Stanley's report at <u>Annex A.</u>

77. It is important that due regard should be given to actual returns that claimants are likely to receive on investments and the availability of a PPO in respect of some or all of the loss. As stated elsewhere in this response, the general availability of PPOs should be a factor that is taken into account when considering the discount rate as a whole. The availability of PPOs does give a claimant the option of a settlement which involves far lower investment risk and that should be built into the overall consideration of the claimants the discount rate is designed to serve. The level of actual returns likely to be

[10] Discount rate: statement laid by Lord Irvine of Lairg in the libraries of both Houses of Parliament on 27 July 2001

received by claimants in general is another vital factor if full compensation is to be achieved. The best way to consider this is to make appropriate overall decisions as to the nature of the risk that a claimant should be expected to meet when investing their lump sum and the type of investment strategies that are available at any given time.

78. Given the length of time over which the investment is required (on average 40 years), due consideration should also be given to the significant returns available from investments held for such long periods[11]. As explained elsewhere in this paper, long term investment strategies are entirely different from short term ones.

Q12: Do you consider that for the purposes of setting the discount rate the assumed investment risk profile of the claimant should be assumed to be:
(a) Very risk averse or "risk free" (Wells v Wells)
(b) Low risk (a mixed portfolio balancing low risk investments).
(c) An ordinary prudent investor
(d) Other.
Please give reasons.

79. Of the options outlined, option (b) would be the most appropriate to reflect the "real world" investment strategies adopted by claimants and providing greater security than option (c). It is clear, based on the expert evidence, that "no risk" options are not available and therefore option (a)[12] is not appropriate. Furthermore, it should be recognised that a claimant with a 'very low risk' appetite could opt for a PPO for the relevant future losses.

80. There is a question as to the usefulness of seeking to put a label against the level of risk that claimants are assumed to take when setting the rate. Equally it is unhelpful to seek to define the type of portfolio that currently reflects any given level of risk, as our experts confirm that investment strategy will inevitably change over time. It is far more important that the approach taken is a "real world" rather than a theoretical approach. Unless the outcome broadly matches reality, the process leads to unfairness, which at the moment leads to over-compensation.

81. When looking at the appropriate risk profile, it is important to understand what happens in practice. The expert reports at Annexes A, B and C address the issue of the level of risk that a claimant will usually be prepared to take. Both Charles Stanley and MVA have

---

[11] http://www3.weforum.org/docs/WEF_FutureLongTermInvesting_Report_2011.pdf page 36

[12] In Wells v Wells, when considering the appropriate test, the House of Lords held that this objective question of what "investment" of damages for future pecuniary loss in personal injuries cases could be "expected" needed to be asked not by reference to (a) an "ordinary prudent investor" but rather (b) an ordinary prudent claimant, given the investing claimants' particular needs. They needed an appropriate investment vehicle which minimises risk so as to be the most reliable guide of a safe, secure and prudent investment for cautious and conservative claimants; so endorsing what had been encapsulated by the Law Commission as a quest for "the best evidence of the real return on [an] investment where the risk element is minimal".

In the application of this test, and based on the evidence before them, their Lordships determined that ILGS was the most appropriate vehicle. It is just possible that ILGS was the right investment to deliver against this objective in 1998 (although it is widely accepted that a claimant should never invest in a single asset class). However, by 2001 the then Lord Chancellor recognised that investment solely in ILGS was not the only measure he should consider and that claimants did not do this in practice. By 2017, as the experts' reports demonstrate, it is neither the right investment nor an approach any reasonable claimant would adopt.

stated that there is no such thing as a "no risk" investment and indeed that if a claimant were to invest a percentage of their damages in ILGS, they would be taking some, albeit limited, investment risk. This is completely at odds with the expert report obtained by the MoJ, which inaccurately equated ILGS with risk free investment.

82. The experts also consider that investment in only one asset class is considered to be riskier than investment in a mixed portfolio. John Frenkel in his report at Annex D goes so far as to state "*It is highly unlikely that any IFA has ever recommended a PI claimant to invest any of their money in ILGS let alone 100%.....It would potentially be negligent for any IFA to advise any investor to invest all of their money in any one particular investment vehicle*.". It is also clear that whilst investment in ILGS may mean that income should be protected against inflation, there is a significant risk to the capital. In section 5 of their report at Annex B, Pannells detail why ILGS cannot be considered to be a risk free option. They state:

> *"It should also be noted that due to the increase in prices of ILGS, investors purchasing ILGS on the secondary market face a guaranteed loss if held to maturity"*

83. What is clear from the experts' reports is that claimants are, in general, prepared to take a low to medium degree of investment risk. This depends on a variety of factors including their cash flow requirements and wider economic circumstances.

84. The various experts have advised that the investment strategies that claimants are advised to adopt are best categorised as (b) low risk. In the "real world" a top down approach will be considered i.e. considering the claimant's future needs, identifying the returns needed to cover that expenditure and identifying the minimum level of risk to meet those returns. Claimants are then asked what level of risk they want to assume and the investment strategy is based on that – see Charles Stanley at paragraph 4.1 and MVA page 4 "Investment Strategies and Risk".

85. The nature of investment risk itself does of course change depending on the time horizons over which the investment is made. An investment in equities alone, when set returns to meet specific needs are required within the next five years, would be considered a high risk strategy, but that level of risk reduces as against the period of time over which the investment is to be made. So a claimant whose needs are only for the next five years will have a very different attitude to risk as against a claimant whose needs are assumed to continue for 70 years.

86. This is a very important factor which weighs against seeking to match the level of risk to any particular asset class over time. The level of flexibility required to meet different claimants' needs (and indeed a claimant's different needs over time) suggests that the flexibility of a mixed portfolio which balances low risk investments will be extremely important.

Q13: Should the availability of Periodical Payment Orders affect the discount rate? If so, please give reasons. In particular:

- **Should refusal to take a PPO be taken as grounds for assuming a higher risk appetite? If so, how big a difference should this make to the discount rate?**
- **Should this assumption apply in cases where a secure PPO is not available?**

87. In general terms, and as part of a broad brush approach to setting the rate, the answer to this question is yes. However, the claimant's choice in an individual case should not be taken into account. PPOs provide a risk free option that was lacking at the time of the *Wells* decision. As such, Section 2 of the Damages Act, as amended in 2005, should be taken into account in the round when the decision maker reviews all relevant factors in the setting the discount rate.

88. The amended Section 2 extends the notional claimant's choice, such that there is an option available which carries no investment risk for certain elements of the claim should the claimant wish to adopt that approach. However, there are factors other than just the financial outcome that have an impact on the claimant's exercise of that choice.

89. The legal framework within which the decision maker is prescribing the discount rate should be wide enough to ensure that they can take account of all relevant factors, including the ability of courts to impose PPOs. The rate should be set so that the claimant can make an appropriate return, whilst preserving capital to the extent that fits with the agreed suggested principles.

90. Whilst the general availability of PPOs is a factor to be considered when setting the discount rate, the choice made by each claimant in their individual case is not relevant. What should happen is that a claimant must be left with a genuine choice as to the nature of the settlement that best suits their circumstances. As we argue elsewhere in this paper, it would offend the principle of full compensation if the discount rate could be varied in each case depending on the choice of the form of award.

91. In any event, it must be noted that no claimant ever takes a pure PPO. The PPO will only be for the future care and care management costs, and on occasion future loss of earnings. Other losses, including future losses to which the discount rate will be applied, for example ongoing treatment or equipment costs, are not suitable for, and never form part of, a PPO.

92. As noted elsewhere in this response and in our responses to the 2012 and 2013 consultations, a broad brush approach should be adopted to the setting of the rate. An artificial quest for precision will increase the prospect of either under or over-compensation and cannot be seen to be fair as between the parties. On the other hand, a broad brush approach would allow all of the relevant factors to be considered in the round, such as the availability of PPOs in the majority of cases, but would not produce an outcome that is unfair either to claimants who, for whatever reason, do not want to take a PPO, or to compensators who are, for whatever reason, unable to fund a PPO securely.

Q14: Do you agree that the discount rate should be set on the basis that claimants who opt for a lump sum over a PPO should be assumed to be willing to take some risk? If so, how much risk do you think the claimant should be deemed to have accepted? Please also indicate if you consider that any such assumption should apply even if a secure PPO is not available. Please give reasons.

93. As already highlighted in this response, the claimant must have a genuine choice so that they can choose the form of award that most suits their particular circumstances and preferences. While there are different reasons why a claimant chooses not to take a PPO, if they have no appetite for investment risk then they would choose a PPO.

94. Some commentators have suggested that claimants cannot obtain a secure PPO where they want one; we do not believe this to be correct. Where a claimant is determined to take a PPO and the defendant is considered secure within the meaning of the Damages Act 1996, the court will award a PPO and insurers know this. As detailed in response to question 7, there are many reasons (not all financial, as evidenced in the Ipsos Mori report) why claimants do not choose the PPO option.

95. The general wide availability of secure PPOs should be one of the factors considered when assessing the level of investment risk that a notional claimant should be expected to take with their lump sum. It is, however, just one of a range of factors that should be taken into account: other factors include the real world investment options chosen by claimant investors and the range of advice available to them.

96. The choices made by individual claimants as to the appropriate form of their award should have not any impact on the calculation of the discount rate; to do so would be to move away from the principle of 100% compensation, which underpins the common law framework to which the discount rate must be applied. The claimant's choice as to the form of damages and the ability to make that choice should be maintained, subject to the overall power of the court.

97. Despite the criticisms by claimant lawyers over recent years of the discount rate remaining set at 2.5%, very few claimants have opted for PPOs. In reality claimants, who will almost invariably have received financial advice, opt to invest in a mixed portfolio as no properly advised claimant would do anything else.

98. The claimant should always remain entitled to full compensation – and should not be either under- or over-compensated. The form of that award should not affect that principle. The discount rate needs to take account generally of how claimants actually invest in practice and the level of risk that it is determined that a notional claimant should be prepared to take.

99. The approach suggested by this question again gives rise to concern that the government is on an artificial quest for precision. What is required is a broad brush approach, which takes account of all relevant factors, which will include the wide availability of secure PPOs.

100. It is important to note that when the House of Lords gave judgment in Wells the court only had power to order a PPO by consent, which Lord Steyn described as "a dead letter". Their Lordships unanimously called for the introduction of the power to award PPO without consent, but this only came into force in 2005. The current position is therefore quite different from that considered by their Lordships and the majority of claimants do now have a genuine minimal risk option available to them.

More than one discount rate?

Q15: Do you consider that different rates should be set for different cases? Please give reasons. If so please indicate the categories that you think should be created.

101. Yes. When setting the discount rate, on balance, the industry has a preference for a 'stepped' dual rate: that is a short-term rate for discounting the first period (say, ten to 15 years) of a claim, and a long-term rate for discounting the remaining years. This approach has the benefit of protecting against the risk of under-compensation for claimants with short term losses while avoiding the over-compensation that would result from ignoring the higher, stable, investment returns a low risk claimant should be able to achieve over a longer time horizon.

102. However, if the Government were minded not to implement a dual rate, this response also comments on the key elements required for a revised single rate framework.

Dual "stepped" Rate

103. Some other jurisdictions use a "stepped" dual rate approach (i.e. two rates for a single case) when setting their discount rate. The model that has been considered in some detail is that which operates in the Canadian province of Ontario. Appendix C sets out a full description of how this model works. In summary, the model has a rate for short term losses (currently 0%) and a separate rate for longer term losses (set at 2.5% since 1981) in the same case. The short term rate applies to the first 15 years of loss in every case while the longer term rate is applied to the later years' losses.

Short-term rate

104. The risk of capital erosion from investment is higher in the early years – see Pannells' report at page 21. Setting a rate for the first 15 years which reflects that risk, would provide protection against capital erosion.

105. In the Ontario model the short term rate (i.e. for the first 15 years) is reviewed annually and is currently set at 0%. The rate for the early years must be fluid and reviewed in a set and predictable fashion on a regular basis to reflect the returns claimants are likely to see in current market conditions. Frequent review for the early years' rate is manageable by compensators as long as the method for calculating the rate is transparent and predictable.

Long-term rate

106. In Ontario, the long-term rate is set by statute and has remained at 2.5% since 1981. Any long term rate should be set by reference to the historic returns achieved when investing over a long period. The long-term stability of this approach benefits both claimants and compensators by creating more predictability (avoiding the incentive to

delay settlement as has been seen with the Lord Chancellor's recent review), and reflecting the relative stability of investment returns over longer time.

107. The long term rate must be set based on realistic returns that could be expected to be achieved for low risk long term investments (40-50 year period). By taking a long term view, any distortions from market cycles, whether that be an economic upturn or downturn, would be smoothed out. Further reviews would only be needed if there is evidence of a permanent shift in the returns expected *over the longer-term*. We would expect that to be highly unusual given the past performance and evidence that returns remain steady and well above inflation over very significant periods of time.[13]

Implementing a Dual Rate

108. Implementation could be simple and transparent as the new short and long term rates would be implemented by way of a variation of the Ogden table multipliers. Practitioners would adapt quickly to the way in which the stepped rate is applied in practice and the Ogden Working Party and others would no doubt publish early guidance.

109. As noted above, uncertainty is unhelpful for all stakeholders. An important test for a dual rate regime will be whether the resulting discount rate(s) is more or less stable than the average returns that can be achieved over a long term investment period (40-50 years).

110. Any dual rate structure introduces the possibility of "cherry picking" – e.g. electing for a lump sum for the period covered by the short-term rate and then seeking a PPO for the remainder of the future loss period. This would distort the overall risk profile applied by the dual rate.

111. This type of gaming needs to be addressed. A possible answer would be to ensure that the approach is applied to each individual head of future loss <u>as a whole</u>, i.e. to cover the entire period of any future loss. The effect of this would be that in respect of any head of future loss, the court must award either a lump sum or a PPO but not both. It would still permit a claimant to have a PPO for one head of future loss (such as care and case management) and a lump sum (using the dual rate) for other heads of future loss, as often happens now.

112. The detail of such a restriction could be delivered via changes to Part 41 of the Civil Procedure Rules, in a way which leaves no residual discretion open to the courts.

<u>Single Rate</u>

113. Whilst the preference of the industry is for the dual rate approach, it is important to note that there are still benefits for claimants and compensators alike in a single rate for all cases, provided it is set using the right framework. The overriding benefit is that of simplicity, in that it provides certainty for all parties but only if it is set based on a modern, transparent methodology. Any system with more than one rate has the potential to add

[13] http://www3.weforum.org/docs/WEF_FutureLongTermInvesting_Report_2011.pdf

a layer of complexity for claimants and for compensators when it comes to assessing the outcome of the claim and reserving against the loss.

114. A single rate system is predictable (although the Ontario approach to a dual rate does achieve this as well) and is the system with which those representing claimants and compensators alike in the UK are familiar given it is the current approach. Whilst that does not of itself mean change should be avoided, familiarity does have obvious advantages.

115. A single rate is also broad brush: the reasons published by the Lord Chancellor in 2001[14] provide a good summary of the benefits of a broad brush approach. A rate set on this approach is more likely to remain stable for a period of several years, which should help create the stability which will enable both claimants and compensators to settle individual cases without having to consider the risk or opportunity of a change in the discount rate.

116. The setting of a single rate needs to take account of the probability that most cases to which it applies involve losses over several decades. It must therefore take a long-term view of returns from investment, recognising that over this length of time certain types of investment, such as equities, are always likely to outperform inflation by a significant margin[15].

Different rates for different heads of loss

117. In 2013 the ABI argued that *"transparency, simplicity and stability are of central importance to assessing the appropriateness of the proposed solutions."* We also noted that *"On the basis that accuracy represents a broad brush approach to achieving this outcome, rather than an artificial quest for precision, we agree that it is a general principle that should be applied."*

118. As noted above, these principles remain of importance. A single rate across all heads of damage is the best way to approach settlement of these claims. We are not aware that claimants have made a compelling argument for any alternative methodology. We do not support different rates for different heads of damages.

119. We have obtained a report from Oxford Economics dealing with relevant economic factors. Full details of their qualifications and experience are set out in their report at Annex E. In their report at section 7.5 they note that "*our forecasts show that mean wage growth 1.0% a year above GDP deflator inflation is consistent with median wage growth at the same rate as RPI inflation."*

120. This is likely to be the reason why claimants have not been pushing in recent years for differential rates for different heads of damage. Wage inflation is, and is forecast to remain, in line with RPI and therefore different rates are not required for heads of loss

[14] Discount rate: statement laid by Lord Irvine of Lairg in the libraries of both Houses of Parliament on 27 July 2001
[15] http://www3.weforum.org/docs/WEF_FutureLongTermInvesting_Report_2011.pdf

which take account of earnings (for example cost of care) when compared with other future losses.

Q16: Please also indicate in relation to the categories you have chosen whether there are any special factors that should be taken into account in setting the rate for that category.

121. As highlighted above, there are no special factors in respect of specific heads of damage which would justify different parts of a claim having a different discount rate applied. As noted in the responses to questions 17 and 18, this could be dealt with by the court if there are exceptional circumstances.

Q17: Should the court retain a power to apply a different rate from the specified rate if persuaded by one of the parties that it would be more appropriate to do so? Please give reasons.

122. Yes. Although the rate set by the Lord Chancellor should be the rate which is used in nearly every case, it is appropriate for the court to retain the power to depart from the prescribed discount rate in exceptional cases.

123. There may be rare examples of situations in which it may be appropriate for one or other parties to the litigation to have the opportunity to raise issues as to the level of discount rate with the court.

Q18: If the court should have power to apply a different rate, what principles should apply to its exercise?

124. The current position, in which the courts have ruled that the power to set a different rate should be exercised only in exceptional cases, remains the correct approach.

125. In order to achieve long term stability for any rate, there is a benefit for exceptional cases to be considered by the court to help remove any cases when the rate as set would not be appropriate. This would mean that where there are truly exceptional circumstances a variation can be applied to the prescribed rate, without a negative impact for the rate as set overall. However, the prescribed rate should only be departed from in truly exceptional circumstances. By their very nature 'exceptional cases' will be hard to define. Any attempt to define the terms on which the court may depart from the prescribed rate would only serve to fetter a court's ability to decide what is truly exceptional.

126. This is not a power that has been overused by the courts, who have consistently rejected arguments that the rate should be departed from in cases where the claimant has not identified any feature which renders the case exceptional[16]. Leaving the power exactly as it is now will continue to produce an equitable result overall.

[16] See Warriner v Warriner [2002] EWCA Civ 81; Cooke v United Bristol Healthcare Trust [2003] EWCA Civ 1370; Harries v Stevenson [2012] EWHC 3447; also in Scotland, Tortolano v Ogilvie Construction [2013] ScotCS CSIH_10

Methodology for setting the discount rate

Q19: Do you consider that there are any specific points of methodology that should be mandatory? Please give details and reasons for your choice.

127. Whatever methodology is adopted, it should be simple and transparent. Stability in the discount rate and therefore certainty as to outcome is a paramount concern and both compensators and claimants should be able to predict with some accuracy when a change will take place and how it will be calculated. The ability of both sides to conclude severe injury cases as quickly as it is reasonable to do so is a significant factor to be considered when looking at how the discount rate is set and reviewed.

128. It is also vital to ensure that whatever methodology is applied, it is flexible enough to adapt to changing economic circumstances. As highlighted above, if the Government determines that the appropriate risk profile for a claimant is that of a low risk investor, then the model applied should match that risk profile. It is not possible to determine that one particular mix of assets, however appropriate for now, will meet that risk profile in the future, especially when that future may be many decades away.

129. Paragraph 59 of the consultation paper sets out the kind of issues that will have to be considered. The examples given do not allow for sufficient flexibility to match reality, nor should the methodology have to cater for this sort of accuracy on points of detail which do not reflect what is likely to happen in practice. The setting of the discount rate cannot be left to mathematical formulae, it is a balance of competing factors to be applied in a broad brush way consistent with the principles outlined in the consultation paper at question 11.

Dual or Single Rate

130. The appropriate methodology to be adopted will depend to a great extent on whether the government prefers to adopt a dual stepped rate, i.e. the options considered in our response to question 15 above, or to continue with a single rate. We have set out in our response to question 20 what we consider to be the appropriate methodology in terms of deciding when and how change should take place.

Real World position

131. The lesson to be learned from the recent review of the rate is that by considering herself bound to set a rate based solely on ILGS yields, the Lord Chancellor applied an approach that was both out of date and divorced from the reality of how claimants are advised to invest in practice. Such lack of flexibility leads inevitably to a breach of the 100% compensation principle.

132. Any new methodology must be future proof. It must allow the decision maker to take note of how claimants approach the investment of lump sum awards in practice at the material time: for example the assumption that claimants as low risk investors will invest in a

portfolio of up to 30% equities, which we argue is the current position and which should form the basis for setting the rate now, might not remain valid in future years.

133. It is not possible to forecast with any accuracy what portfolio of assets a claimant will hold in the future. It is, however, possible to predict with confidence that this portfolio will, over a longer period of time, generate positive real returns. The methodology for predicting the single rate (or the long term part of a dual rate) should be based not on current returns in the market, but on a broad brush, long term view of net returns.

Taxation

134. With regards to tax, this issue was addressed in response to the 2012 and 2013 consultations as follows:

Although tax liabilities will vary by individual claimant, the base presumption is that all investment returns should be reflective of tax liability at the basic rate.

135. The Government should be adopting a real world rather than a theoretical approach to investments and our view on tax liabilities is largely unchanged. It is clear from considering a real world approach with the experts that individual claimants will face different tax liabilities. MVA state in their report:

Most Personal Injury Clients are either non or basic rate tax payers. By investing the monies in different tax wrappers, e.g. Insurance Company Bonds/Collectives and ISAs (where appropriate) we can greatly mitigate Income and Capital Gains Tax. In some years there is no tax to pay. In addition substantial income can be paid free of Income Tax via Structured Settlement/Periodical Payment Orders.

136. In other jurisdictions, for example Ireland, personal injury claimants are specifically exempted from tax on investment income.

Investment advice fees

137. The cost of ongoing investment advice is not recoverable as damages or as a component of legal costs (unlike the cost for advice received during the settlement process)[17]. Fees for advice are not set and will vary significantly, as will the frequency at which advice is needed.

138. It is already customary for the charges for managing an investment fund to be deducted from the returns obtained, so that the return on investment is described as net of charges. The same approach could potentially be applied to an allowance for fees for investment advice, which would help to contain the cost of advice to a reasonable level. The approach adopted to the discount rate could build such fees into the discount rate itself. In effect, the discount rate would be calculated by reference to returns that are net of charges both for management and fees for advice.

[17] Eagle v Chambers [2004] EWCA Civ 1033

139. That should ensure an outcome that is both fair to claimants and to compensators. Claimants will have access to and be able to afford the advice, but only when necessary and in a competitive market. Compensators are not faced with meeting that future cost as a theoretical construct, with the inevitable difficulties inherent in any situation where the cost and control of purchasing a service is separated.

Rounding

140. In response to the 2012 consultation, the issue of rounding was addressed and our position has not changed:

Subject to these overriding considerations, the previous reasoning given by the Lord Chancellor in 2001, that a rounding of one half percent supports the concept of simplicity, remains valid.

However one of the factors considered by Lord Irvine in 2001 was the need to take account of matters "…relevant to the setting of a discount rate which is just between claimants as a group and defendants as a group". In effect this does indicate that the impact on defendants as a group (whether covered by insurance or funded by the public sector) is relevant to the rounding exercise. As we have set out in the response to Question 15 the impact on defendants as a group is considerable. This should certainly be justification for a rounding up of at least one half percent.

141. The reference to *just between claimants as a group and defendants as a group* is no more than a reflection of the 100% compensation principle and avoiding under or over compensation.

142. A rounding of 0.5% remains appropriate. Rounding to a smaller percentage highlights an artificial quest for precision, which undermines certainty. As we have said in response to earlier questions a broad brush approach should be preferred.

Inflation

143. The report from Oxford Economics (Annex E) makes it clear that CPI is now the preferred official measure of inflation. The use of RPI in ILGS is likely to build in excessive inflation assumptions in a single rate to apply to all heads of damage and therefore lead to over-compensation.

144. However, in a claim for personal injury which includes future losses the appropriate measure of inflation also needs to account for wages inflation and for owner occupier housing costs. Oxford Economics highlight that both are running at or very close to RPI and on that basis, and accepting that there is no truly accurate index, we consider that RPI is the more appropriate index of inflation for setting of the discount rate as it provides for greater fairness as between the parties.

Split basis

145. The EU Directive Solvency II sets out capital requirements for insurers to be set so as to almost eliminate the risk that insurers do not hold sufficient investments to meet obligations to policyholders or claimants claims, even in very adverse scenarios. Insurers must hold an excess of assets over their liabilities that is at least equal to their capital requirement.

146. To first value liabilities under Solvency II is a two-step process for insurers:

- the insurers' best estimates of future liabilities are discounted using positive, risk-free discount rates which is specified by the European regulator, the European Insurance and Occupational Pensions Authority (EIOPA) and, for long durations, tend towards the Solvency II Ultimate Forward Rate, set by EIOPA at 4.2%
- a Risk Margin is added to these discounted values (note that nothing is added to the rather than to the discount rates) with the intention of giving market consistency - that is, to reflect the price at which an insurer might transfer its liabilities to another insurer, rather than fulfil them itself over time.

147. The best estimate of liabilities, Risk Margin and capital requirements are each specified in insurance legislation for a specific and differing purpose and methodology. Given this, care is therefore required before using a split basis for the discount rate that relies on any apparent parallels with insurance solvency legislation.

<u>When should the rate be set?</u>

Q20: Do you agree that the law should be changed so that the discount rate has to be reviewed on occasions specified in legislation rather than leaving the timing of the review to the rate setter? If not, please give reasons.

Q21: Should those occasions be fixed or minimum periods of time? If so, should the fixed or minimum periods be one, three, five, ten or other (please specify) year periods? Please give reasons.

148. These questions have been taken together. As highlighted above, any method applied must be simple and transparent. Equally there should be an element of predictability about when the rate will change.

149. The appropriate approach to take on the timing of a rate review will differ depending on whether the government prefers a dual or single discount rate.

<u>Dual rate</u>

150. If a Dual Rate approach were to be adopted, then a different set of factors need to be considered for the short term rate and the long term rate.

151. For the short term rate, this should be reviewed frequently, most likely annually, and should be adequately predictable. This could be achieved by applying a set formula to the adjustment. Given that the review would happen annually, and apply only for the short term rate, any movement in the rate is likely to be minimal and therefore any uncertainty risk can be managed by both claimants and compensators.

152. As noted above in response to questions 15 and 16, the benefit of a longer term rate for both claimants and compensators is long term stability. That rate should be set by reference to historical long term (40-50 year) averages and should remain in place for significant periods, for example in Ontario the long term rate is set by statute and has been fixed at 2.5% since 1981.

<u>Single rate</u>

153. If the current single rate approach were to be retained, then the review should happen at intervals determined by the movement of relevant investment returns or identified economic markers. These could be set out in legislation and it is a meaningful movement in anticipated returns or the economic marker that should trigger the change rather than specified dates.

154. For a single rate approach, using a fixed or minimum period would not be appropriate. The problem with relying on a specific time period is twofold:

- Firstly, it is likely to drive behaviours by both compensators and claimants alike. If a change is due to happen on a specified date then settlements are likely to be delayed until the change has been announced and it will slow the claims process down considerably as has been seen over recent months; and

- Secondly, whatever time period is chosen it may prove to be inappropriate. An annual rate change would be too onerous and a five year minimum period could mean that economic change shortly after a rate review makes the decision inequitable on one party or another for a significant period of time. Equally a fixed period will almost inevitably fail to match when a change in the rate is actually needed.

155. A review period linked to defined economic markers means that the rate is flexible enough to change when it needs to do so, but that such change is likely to be incremental, which is easier for all parties to accommodate. The type of economic marker that the government may wish to consider needs careful consideration as it will be essential for the measures chosen to reflect investment returns net of inflation.

Q22: When in the year do you think the review should take effect? Please give reasons.

156. The announcement on 7th December 2016 that the change to the discount rate would be announced by the end of January 2017 caused insurers significant operational difficulty. This is because the announcement was made during the industry's annual reporting season, when insurers were in the process of compiling their end of year accounts, the content of their annual report and the year-end regulatory reporting disclosures, in accordance with the rules of the Prudential Regulation Authority (PRA). The accounts and Annual Reports were to be completed by around the end of January and in addition this year (for the first time), insurers were preparing their first Solvency II public disclosure. As a result, the review of the discount rate was extremely difficult to properly account for in this environment.

Dual rate

157. Were the government to prefer a dual rate, then it is assumed that the short term rate would be reviewed at regular intervals. Changes in the rate would be predictable and incremental and would not create the significant problems for insurers that the timing of the last announcement created. As below, an announcement outside of insurers accounting period would be preferred. Any long term rate should be set for a very significant period in any event to maintain certainty.

Single rate

158. If the government prefers a single rate, then any announcement made during this accounting period creates significant difficulties for insurers. An announcement made not before 1st April and not after 30th November in any year would be vital.

Q23: Do you agree that the rate should be reviewed at intervals determined by the movement of relevant investment returns? If so, should this be in addition to timed intervals or instead of them? What do you think the degree of deviation should trigger the review?

159. See response to questions 20 and 21. The economic markers to be used, which would be instead of any fixed timed intervals, will need to reflect the performance of the economy as well as investment returns and be measured over an appropriately long period.

Q24: Do you agree that there should be a power to set new triggers for when the rate should be reviewed? If not, please give reasons.

160. See response to questions 20 and 21. The mechanism for both review and setting the rate needs to be transparent and certain. If the markers which trigger the review of the rate can themselves be changed, this creates uncertainty. Additionally the markers themselves need to be capable of lasting for a sustained period, to create stability in the mechanism.

161. Therefore, extreme caution should be taken in providing for any power to set new triggers, although some residual power should be retained in the statute. One option would be to require the decision maker to consult publicly before setting any new triggers and to require any such change in the regulations to be subject to scrutiny in Parliament via the affirmative resolution procedure.

Q25: Do you consider that there should be transitional provisions when a new rate is commenced? If so, please specify what they should be and give reasons.

162. The answer to this question is dependent on whether the government opt for a single rate or dual rate. Equally it will depend on the decisions made as to how and when the rate is to be reviewed.

163. The recent change in the rate has created significant inequities between the parties, purely as a result of the size of the change and the resulting significant increase in damages. Compensators now find that they were significantly under-reserved for cases and in some liability cases, customers will now find that their limit of indemnity in their insurance policy is exceeded. This will have very significant ramifications for small and medium size enterprises (SMEs), some of whom now find themselves insufficiently insured against an accident that could have happened several years before. In the most extreme cases, some SMEs may go out of business as a result.

<u>Dual rate</u>

164. If a dual rate is preferred and a long term rate is set for a sufficiently long period, then the shock of changes to the short term rate is never going to be as significant. As set out above, the short term rate in such a model should be reviewed frequently and in a

transparent and predictable manner. As a result, changes to the short term rate are likely to be small and predictable in any event.

165. If a dual rate is preferred, and with the caveats set out above in place, then there is no need for transitional provisions in the review mechanism for the short term rate.

Single rate

166. If the government decide that a single rate option is the preferred option, then it is imperative that the rate is reviewed by reference to economic markers as set out in response to the questions above. That should then allow for smaller incremental changes over time, which avoids the shock impact that large changes introduce to the claims settlement process i.e. where current claims are now worth many millions more than their previous value.

167. If such a transparent and predictable process is introduced, then it is unlikely that there will be a need for transitional provisions.

Who should set the rate?

Q26: Do you consider that the discount rate should be set by:
a) A panel of independent experts? If so, please indicate how the panel should be made up.
b) A panel of independent experts subject to agreement of another person? If so, on what terms and whom?
Would your answers to the questions above about a panel differ depending on the extent of the discretion given to the panel? If so, please give details
c) The Lord Chancellor and her counterparts in Scotland or another nominated person following advice from an independent expert panel? If so, on what terms?
d) The Lord Chancellor and her counterparts in Scotland as at present?
e) Someone else? If so, please give details.

168. Ultimately political accountability is needed and important when setting the rate. As such, the power to set the rate should rest with the appropriate Secretary of State so that a policy decision is taken for which the decision maker is politically accountable rather than the quasi – judicial process that was adopted for the recent review.

169. As set out in Appendix A, the decision does not impact on the common law framework, it is a statutory decision that merely applies a rate to be adopted within that common law framework. The decision was historically judicial but the Damages Act 1996 clearly changes that position.

170. In order to assist the decision maker in the performance of their statutory function, an independent panel should provide their input. The panel should be made up of stakeholders with expertise in past investment returns and volatility of the asset classes that could be included within a diversified portfolio: this would include wealth managers, actuarial firms and independent financial advisers. In addition to considering the advice of the independent panel, the decision maker should also have a statutory obligation to consult with representatives of both claimants and compensators before setting the discount rate.

171. As indicated elsewhere, any IFA involved with the panel should be experienced in managing funds post settlement rather than in providing advice on the form of award pre-settlement. Those providing advice pre-settlement are likely to have a conflict of interest, and consideration should be given as to whether any expert has any other potential conflict because of their existing role.

172. The panel should also have and apply expertise in real-world investment options and outcomes. As we previously highlighted, there are aspects of the report provided by the Lord Chancellor's expert panel in 2015 that are of concern and should be judged against the independent expert reports commissioned to accompany this response. The notion that a claimant could avoid risk by investing in a single asset class and the proposition that ILGS (especially when held to redemption) represent a risk-free and suitable investment for claimants are both shown to be badly flawed.

173. The precise make-up of any panel would, of course, be affected by the decisions made by the Government in respect of the other questions raised in this consultation paper.

174. Once again, the answer to this question will vary dependent on whether a single or dual rate is adopted and would vary dependent on what process is decided upon for deciding when the rate should be reviewed.

175. It may be possible for example, if a dual rate were preferred, for the setting of the short term rate to be entirely formulaic, in which case no input from an expert panel would be required.

176. An independent panel would only be instructed to report if a relevant trigger point for a review to take place was reached. Ultimately, the decision would be one for the decision maker alone, but after receiving advice from the independent panel. Neither the trigger event itself nor the independent report would lead automatically to a change in the rate, although it would be desirable for the process to be "timetabled", either within legislation or by requiring the decision maker to announce a timetable when the review is triggered.

Periodical Payment Orders

Q27: Do you consider that the current law relating to PPOs is satisfactory and does not require change? Please give reasons.

177. Yes, subject to the point about application to Scotland below. The law in relation to PPOs is working effectively, claimants need to have the choice between a lump sum and a PPO and this is being delivered by the current legislative framework.

178. It is right that the Court has both the duty to consider whether to award damages in the form of a PPO and also the power to do so. The Court rules that support the primary legislation in the Damages Act 1996 also provide that the Court should have regard to all the circumstances of the case and, in particular, the form of award which best meets the claimant's needs taking into account the factors listed in the accompanying Practice Direction. Those factors include whether there is any deduction for contributory negligence, the parties' preferences, the reasons for those preferences and the claimant's financial advice.

179. The Court's discretion is an effective control mechanism in practice and we are unaware of any complaints about its use.

Scotland

180. In response to the 2013 consultation, the ABI noted as follows:

Throughout this response the ABI has considered the economic position across the UK generally and not just England and Wales. The only material legal or economic difference between Scotland and Northern Ireland is the availability of PPOs. Northern Ireland has the same statutory power as exists in England and Wales for the courts to make an award by way of PPO; numbers of claims generally are lower but we believe the take up of PPOs is similar. However, as noted in our response to Question 7, there is a link between the discount rate and PPOs in that, when setting the discount rate, a policy decision needs to be made as to the level of risk that a hypothetical claimant should be deemed to assume when opting for a lump sum award instead of a PPO, in light of the considerable financial and other advantages of the latter. The availability of PPOs that can be imposed by the court, means that where appropriate, there is a very low risk solution available to the claimant. If the position on PPOs is not reviewed in Scotland and brought in line with England, Wales and Northern Ireland, there would be an artificial differentiation in the policy considerations, which does not reflect the true economic position across the UK.

181. Our position in relation to Scotland remains unchanged since that 2013 response. The position in Scotland needs to be consistent with that in the rest of the UK, we refer to our further comments on this point raised in our response to question 6.

Q28: Do you consider that the current law relating to PPOs requires clarification as to when the court should award a PPO? If so, what clarification do you consider necessary and how would you promulgate it?

182. If there are going to be any changes to the primary legislation, the provisions on PPOs could be improved by clarifying:
   (a) in Section 2(4) of the Damages Act that the continuity of payment under a PPO is reasonably secure if the source of payment is the MIB; this has been established by the Courts (in *Thacker v Steeples & MIB*), but would benefit from being codified in legislation.
   (b) that claimants of full age and capacity have the final say on the form of award when both parties are agreed on that form of award. All settlements involving children and those who lack capacity must be approved by the Court and, during this exercise, the Court will always consider the suitability of the agreed form of award. There is also a train of judicial thought that the final say still rests with the Court when a claimant is of full age and capacity. This is at odds with the principle that such claimants should have freedom of choice when settling their claims and also the acknowledgement in Section 4(5) of the Damages Act that PPOs can be made pursuant to an agreement as well as an order of the Court.

Q29: Do you consider that the current law relating to PPOs should be changed by creating a presumption that if a secure PPO is available it should be awarded by the court? If so, how should the presumption be applied and on what grounds could it be rebutted?

Q30: Do you consider that the current law relating to PPOs should be changed by requiring the court to order a PPO if a secure PPO is available? If so, what conditions should apply?

183. Question 29 and 30 have been taken together.

184. The current law does not need to be changed. As highlighted previously, claimant choice must be paramount in this process. If a claimant does not want a PPO, for whatever reason, then they should not be forced to accept one. The Court should retain the power to order a PPO where it is deemed to be in the claimant's best interests and in determining that position should take account of the parties' views and preferences.

185. The central principle should be full compensation rather than the form of any particular award. For reasons that we have set out elsewhere in this response, claimants will, for their own reasons, either want to take a PPO for some of their future losses or a lump sum. There are a variety of reasons for this. Where the claimant has capacity, they should have that choice.

Q31: Do you consider that the cost of providing PPOs could be reduced? If so, how.

186. The main driver of the cost of PPOs for regulated insurers, and which is distinct from the cost borne by NHS Resolution and MIB, is in the reserving requirements and capital requirements they must meet under the EU Solvency II Directive, the EU-wide prudential regulatory regime on the taking-up and pursuit of the business of insurance and reinsurance. In the UK, the Prudential Regulation Authority (PRA) is the National Competent Authority responsible for its implementation.

<u>Solvency Capital Requirement</u>

187. Under Solvency II, when valuing their liabilities firms are required to form a best estimate view of all future obligations they owe to policyholders and claimants. To reflect the uncertainties implicit in this estimation, firms are required to hold a capital buffer – the Solvency Capital Requirement (SCR) – over and above the best estimate of their liabilities. This must be sufficient for a firm to remain solvent with a probability of 99.5% over a one-year period.

188. For PPOs specifically, the size of the SCR needs to reflect significant uncertainty that is driven by three factors:
    - the duration of the liabilities, typically around 40 years but for some as long as 90 years. A high level of capital is required to reflect the range of eventualities that could transpire during this time horizon
    - longevity risk, due to a lack of statistically sufficient data related to the PPO claimant population; this is increased further by the long-term nature of the liabilities
    - indexation uncertainty. PPOs are indexed using ASHE[18], which insurers are unable to hedge against by holding investments with an equivalent indexation. Insurers instead must use assets that represent a proxy for this, which still leaves them exposed to index basis risk. Again, this risk is increased further due to the long-term nature of the liabilities.

189. Typically, the capital requirements of PPOs are equal – and in addition – to the value of the reserves that insurers are already holding thereby essentially doubling the cost.

<u>Risk Margin</u>

190. Another component of Solvency II contributing to the cost of PPOs for insurers is the Risk Margin. This is an addition to the best estimate of liabilities that firms need to hold. It is intended to reflect the risk premium, associated with non-hedgeable risks, of transferring the liabilities to a third party, hence making the liabilities side of the regulatory balance sheet more market consistent – a key principle of Solvency II. Non-hedgeable risks include underwriting risk and operational risk but do not include market risk as the best estimate of liabilities is already calculated using risk-free rates.

[18] Annual Survey of Hours and Earnings

191. The design of the Risk Margin is deeply flawed – as has been acknowledged by the PRA and by HM Treasury. Its size is too big and it is too sensitive to interest rates. This acts as a strong disincentive for insurers to write long-term business which offers protection against longevity risk, such as annuities. PPOs also have these same characteristics but have the additional problem that they are not written as a customer product, but ordered by the court.

Matching Adjustment eligibility

192. The Matching Adjustment is another important component of the Solvency II framework. It is designed to recognise that when insurers invest with a 'buy-and-hold' strategy in order to match their long-term liabilities, they have a much more limited exposure to short-term market movements. PRA approval is required to use the Matching Adjustment, and it is used extensively by UK life insurers with annuity books. However it is not currently used by any insurers for PPOs, despite the same principle at play for managing annuity liabilities as for PPO liabilities. The restrictive eligibility requirements of the Matching Adjustment mean that PPO liabilities do not currently qualify due to the uncertainty of their cashflows.

193. Carefully thought through changes to these three aspects of Solvency II – Solvency Capital Requirement, Risk Margin and Matching Adjustment eligibly – could lead to a reduced cost of PPOs for insurers, whilst still maintaining a very high level of policyholder and claimant protection.

194. Whilst there is some scope to review the PRA's local implementation of Solvency II in these areas, a more materially and mutually beneficial outcome will require change at the European level (or, post-Brexit, change to UK legislation and regulation).

Q32: Please provide details of any costs and benefits that you anticipate would arise as a result of any of the approaches described above.

195. See response to question 31. Clearly any change in the implementation of Solvency II leading to a beneficial outcome will have a positive impact. Without such measures, then any steps introduced that increase the propensity for PPOs will have an increased cost burden for insurers which could affect the wider premium paying public.

Q33: Please provide any evidence you may have as to the use or expected use of PPOs in the light of the change in the rate and more generally.

196. It is too early to say what impact the decreased discount rate will have on the uptake of PPOs. That said, it is inevitable that a discount rate of minus 0.75% will mean that there is a reduced propensity for PPOs because lump sum awards will be significantly higher and more attractive.

197. It is important to record that a PPO tends only to be used for care and care management costs (and occasionally future loss of earnings). There are numerous other future losses

in such cases which will still take the form of a lump sum and to which a discount rate therefore has to be applied.

198. As noted above, the uptake of PPOs has been declining generally, even with the discount rate at 2.5% and their use is likely to reduce further in light of the reduction in the discount rate.

199. PPOs are likely to remain appropriate in cases of minors and other claimants who lack capacity, or to claimants with a very short life expectancy, or where there is a significant dispute over life expectancy. Even in those claims where life expectancy is a material factor, the propensity of PPO use is expected to reduce.

Impact Assessment/Equalities Statement

Q34: Do you agree with the impact assessment that accompanies this consultation paper? If not, please give reasons and evidence to support your conclusions.

200. The Impact Assessment gives 4 options for addressing the discount rate:
   - Option 0: Do nothing. Continue to set the rate under section 1 of the Damages Act 1996 in accordance with the current legal framework.
   - Option 1: Change the legal framework under which the discount rate is set, in particular changing assumptions about the level of risk of the investment portfolio against which the rate should be set.
   - Option 2: Specify how frequently or under what considerations the discount rate should be reviewed.
   - Option 3: Set up an expert panel appointed to set or advise on what the personal injury discount rate should be.

Option 0

201. As highlighted in answering Question 1, the interpretation of the legal framework as exercised by the Lord Chancellor in reducing the discount rate to minus 0.75% is wrong in principle and in law. Theoretically, therefore, it would be possible to do nothing and continue to set the rate under section 1 of the Damages Act 1996 but do that in accordance with the current legal framework.

202. However, there are significant areas of disagreement as to the interpretation of the current legal framework. This level of disagreement in itself suggests that the law on setting the discount rate is not working as it should do. Because of this, Option 0 is not a viable option.

Option 1

203. As stated above, the level of disagreement as to what the current legal framework means, suggests that the law on setting the discount rate is not working as it should.

204. The current interpretation of the legal framework has led to the flawed theoretical assumption that claimants are completely risk averse and that this should be reflected by a 100% reliance on ILGS yields. Because of this, a change in the legal framework is required to prevent such flawed assumptions being seen as the required approach and to reflect the proper level of risk of claimants' investment portfolios in practice.

205. In principle, claimants should not be put in a position where they are required to take anything more than a low/medium investment risk. Claimants are not in the position of an ordinary prudent investor, in that they are reliant on the ability to realise income and assets at defined times and may not have other sources of income or capital on which they can draw.

Option 2

206. Reviews at fixed intervals are not supported as this would just add cost with minimal gain to either claimants or defendants. As has been shown by the recent review, settlement of claims slows down when a review is imminent as both sides to the negotiations wait for the outcome. Building a framework that creates these delays is not in anyone's best interests.

207. Instead, we have set out in our response how the government should approach the timing of reviews whether they retain the single rate approach or move to a dual rate process.

Option 3

208. As a starting point we suggest having an understanding of past investment returns and volatility for assets classes that could be included within a diversified portfolio. We suggest that real world independent advisers such as wealth managers (e.g. Investec and LGT Vestra, who were consulted by Pannells when preparing his report at Annex B), actuarial firms and independent financial advisers are consulted to assist with this. The IFAs needed for this exercise are those who advise claimants and other similar investors on the investment of awards, not necessarily the specialist IFAs who are retained currently **before** settlement to advise on the choice between PPO and lump sum. Such specialist IFAs in our view have a distorted approach to the questions of investment risk, because they are having to advise on the extreme risks a claimant might hypothetically face.

209. It is vital that a "real world" view of investment is taken, rather than a narrow theoretical view. It is clear from the expert evidence that we have provided that investment in ILGS as a single asset class never happens in the real world (indeed investment in any single asset class is strongly discouraged) and the government were not adequately appraised of that based on the expert panel report obtained.

Q35: Do you think we have correctly identified the range and extent of effects of these proposals on those with protected characteristics under the Equality Act 2010?

210. The discount rate is typically only used in cases of more serious injury likely to lead to lasting disability. Accordingly, many of the claimants affected by the current level of the rate or by any change in it are, by their nature, likely to be considered as disabled. As indicated in our response to the first consultation we do not consider that this is a matter which should be taken into account in any equality impact assessment. Alternatively, for these purposes all claimants affected should be considered equally.

Q36: If not, are you aware of any evidence that we have not considered as part of our equality analysis? Please supply the evidence. What is the effect of this evidence on our proposals?

211. Not applicable.

Association of British Insurers
11 May 2017

<u>Appendix A</u> - The ABI's interpretation of the law as it stands

The wording of the statutory power as set out in section 1(1) of the Damages Act 1996 permits the Lord Chancellor to set a rate for the Courts to adopt as the assumed rate of return from investment. The <u>only</u> statutory constraint is Section 1(4) of the Act which states that "before making an order under subsection (1) the Lord Chancellor shall consult the Government Actuary and the Treasury".

However, the Lord Chancellor's recent decision makes it clear, that she still considers that the legal parameters relating to the setting of the discount rate are defined by section 1 of the Damages Act <u>and</u> the decision of the House of Lords in *Wells v Wells* [1999] 1 AC 345 (16 July 1998). In part we agree that the Lord Chancellor is so constrained, but not to the extent that she considers herself to be.

In *Wells* the House of Lords decided four main points 1) the 100% principle; 2) the ordinary prudent claimant's appropriate investment vehicle; 3) ILGS as the best guide / evidence; and 4) a 3% rate of return as the appropriate judicial guideline.

<u>The 100% principle</u>

The House of Lords in *Wells v Wells* (upholding a long line of previous authority) held that the object of the award of damages for future expenditure should be to place the claimant as nearly as possible in the same financial position as he or she would have been in but for the accident: no more, and no less, than the net loss.[19] Lord Steyn called this the *"the 100% principle"* which was "*well established and based on high authority*"[20].

This point was a point of principle, on which the House of Lords was making an authoritative ruling on the nature and purpose of personal injuries damages at common law for future pecuniary loss, as determined by the Courts. It is not a matter from which the Lord Chancellor would be entitled to depart when prescribing a rate of return under section 1(1). That is because it is only the <u>rate of return</u> which the Lord Chancellor is empowered to prescribe, and that rate of a return is an input into a common law framework of personal injury damages which the Courts design. Section 1(1) does not empower the redesign of the framework itself. The Lord Chancellor would not be entitled to approach the rate of return with the objective of achieving 90% recovery for claimants; nor the objective of achieving 110% recovery.

<u>The Ordinary Prudent Claimant's Appropriate Investment Vehicle</u>

The House of Lords (overturning the Court of Appeal) held that the expected investment of personal injuries damages awarded for future pecuniary loss was represented by the real return on investment with a minimal risk element, as the appropriate investment vehicle for a cautious and conservative ordinary prudent claimant. As the Court explained, this objective[21]

[19] Lord Hope at 390B, also Lord Lloyd at 364A, 373A; Lord Steyn at 382H; Lord Hope at 390B; Lord Clyde at 394D and Lord Hutton at 398E.
[20] Lord Steyn at 383A.
[21] Lord Steyn at 386A.

question of what *"investment"* of damages for future pecuniary loss in personal injuries cases could be *"expected"*[22] needed to be asked not by reference to (a) an *"ordinary prudent investor"* but rather[23] (b) an *ordinary prudent*[24] *claimant*[25], given investing claimants' particular needs.[26] They needed an *appropriate investment vehicle*[27] which *minimises risk*[28] so as to be the *most reliable guide*[29] of a *safe*[30], *secure*[31] and *prudent investment*[32] for *cautious and conservative*[33] claimants; so endorsing[34] what had been encapsulated by the Law Commission as a quest for "*the best evidence of the real return on [an] investment where the risk element is minimal"*[35].

This was a point of principle on which the House of Lords was making an authoritative ruling, on the true nature and purpose of the expected investment of claimants' common law personal injuries damages for future pecuniary loss, as determined by the Courts. It turned on the recognition that the investment to be expected in identifying and applying the appropriate rate of return for claimants' personal injuries damages awards for future pecuniary loss had to be one suitable for a *prudent investing claimant*, rather than an *ordinary prudent investor*. That conclusion of law itself followed from the 100% principle.

This is also not a matter from which the Lord Chancellor would be entitled to depart when prescribing a rate of return under section 1(1). That is because the choice of the *ordinary prudent claimant* approach went to the design of the common law framework of personal injuries damages. Here again, the Lord Chancellor is empowered to prescribe an appropriate input for use within that framework.

ILGS as the best guide / evidence

The House of Lords held that the *appropriate investment vehicle* which *minimises risk* so as to be the *most reliable guide* of a *safe*, *secure* and *prudent investment* for *cautious and conservative* claimants, being "*the best evidence of the real return on [an] investment where the risk element is minimal"* was[36] Index-Linked Government Securities (ILGS), available after 1982[37] as a virtually risk-free investment[38] which had (radically[39] and fundamentally[40]) changed the economic landscape, background and circumstances[41].

[22] Lord Steyn at 386A (*"the type of investment that [claimants] can reasonably be expected to make"*).
[23] Lord Lloyd at 366H, 367C; Lord Steyn at 386B; Lord Hope at 392D; Lord Clyde at 396B; Lord Hutton at 403C.
[24] Lord Lloyd 367C; Lord Steyn at 386H; Lord Hutton at 404A.
[25] Or *"plaintiff"*, in the then terminology.
[26] Lord Lloyd at 366G; Lord Steyn at 386B-F; Lord Hutton at 403C-D.
[27] Lord Steyn at 384 (*"the appropriate investment vehicle"*).
[28] Lord Hope at 392D-E (*"investment … which will as nearly as possible guarantee the availability of the money as and when it is required"*).
[29] Lord Hope at 391H (*"the most reliable guide"*), 392F (*"the best guide"*); Lord Clyde at 396D (*"the preferred choice"*).
[30] Lord Steyn at 385A (*"a safe investment"*).
[31] Lord Hope at 391H (*"a secure investment"*)
[32] Lord Hope at 392D-E (*"a prudent investment"*); Lord Lloyd at 368E-F (*"prudent investment policy"*).
[33] Lord Steyn at 386F (*"cautious and conservative"*).
[34] Lord Lloyd at 374B; Lord Steyn at 385C; Lord Hutton at 402C.
[35] The Law Commission: see Lord Lloyd at 370F-G and Lord Hutton at 402C.
[36] Lord Lloyd at 373C; Lord Steyn at 387A; Lord Hope at 393B; Lord Clyde at 396D; Lord Hutton at 403C.
[37] Lord Lloyd at 364H; Lord Steyn at 384H; Lord Hutton at 400D.
[38] Lord Lloyd at 365B; Lord Steyn at 385A-B; Lord Hope at 392B; Lord Clyde at 396G.
[39] Lord Steyn at 384H.
[40] Lord Hope at 391G.
[41] Lord Hutton at 400D, 402A.

This was the application of the point above, based on the economic landscape with which the House of Lords was dealing, and with the benefit of the evidence, research and commentary before the Court. It was 'binding' in two respects. First, no decision maker (whether a court or the Lord Chancellor) could rationally have chosen a different guide than ILGS in that economic climate, and when evidence, research and commentary had been addressed by the highest Court in the land. Secondly, the House of Lords went on to decide the fourth point (below), and identify a judicial guideline[42] to be applied by Courts *"until"*[43] the Lord Chancellor prescribed by order a rate of return. That guideline (3%), subject to any flexibility[44] in particular cases, was deliberately intended to be durable: Courts were to use it, until the Lord Chancellor prescribed a rate by order, absent a marked[45] or very considerable[46] change in economic circumstances. The House of Lords was careful not to say that the guideline was 'binding' on the Lord Chancellor. It could not have been their Lordships intention to set for all of time a single investment class as satisfying the needs of the ordinary prudent claimant whatever the fortunes of that asset class.

This point is a matter from which the Lord Chancellor could lawfully depart, provided that she adhered to the principles identified in the first and second points. She is not obliged to adopt ILGS as the suitable risk-protected investment vehicle, on which to base the rate of return. She should have asked herself – considering evidence, research and commentary – whether there is, in the current economic circumstances, a more appropriate investment vehicle for the ordinary prudent claimant, applying point 2. Indeed, the Lord Chancellor – considering evidence, research and commentary – is obliged (by point 2) to adopt the most appropriate investment vehicle for the ordinary prudent claimant. Any vehicle which resulted in either under- or over-compensation, would be incompatible with point 1, which is a constraint on the exercise of her power.

A 3% rate of return as the appropriate judicial guideline.

The House of Lords decided – in arriving at a judicial guideline in 1998 – that (by a 4-1 majority[47]) it would take the net average return of ILGS over the past three years to arrive at a general and simple, single rate of return of 3%[48].

This was a judgment based on the third point (itself an application of the second point). It was 'binding' in one respect only. It was binding on courts making damages awards, as the judicial guideline[49] to be applied by them *"until"*[50] the Lord Chancellor prescribed by order a rate of return. The 3% guideline, subject to any flexibility[51] in particular cases, was to be used, until

[42] Lord Lloyd at 375E; Lord Steyn at 388D.
[43] Lord Lloyd at 376A-B, Lord Steyn at 388C-D; Lord Hutton at 404H.
[44] Lord Lloyd at 375F; Lord Steyn at 397H.
[45] Lord Steyn at 388E.
[46] Lord Hutton at 404H.
[47] Lord Steyn at 388D; Lord Hope at 393E; Lord Clyde at 398A; Lord Hutton at 404F.
[48] Lord Steyn at 388D; Lord Hope at 393E; Lord Clyde at 397H; Lord Hutton at 404F.
[49] Lord Lloyd at 375E; Lord Steyn at 388D.
[50] Lord Lloyd at 376A-B, Lord Steyn at 388C-D; Lord Hutton at 404H.
[51] Lord Lloyd at 375F; Lord Steyn at 397H.

the Lord Chancellor prescribed a rate by order, absent a marked[52] or very considerable[53] change in economic circumstances. But it was not binding on the Lord Chancellor. The House of Lords was very well aware of the Lord Chancellor's function and urged him to exercise it. But they did not begin to dictate what rate or rates of return he would come up with when he did so, whether now or in the future.

[52] Lord Steyn at 388E.
[53] Lord Hutton at 404H.

Appendix B – Over compensation examples

Example 1: A 25 year old male is severely disabled in a car crash and cannot work again. He has a degree and it is determined he would have earned £50,000 a year until retirement at 65. His cost of care is going to be £30,000 a year for the rest of his life. He receives a lump sum at -0.75 Discount Rate, but is then able to achieve a real return on investment of 2%.

Lump sum at -0.75 DR:	£4,502,895
Lump sum at 2% DR:	£2,300,070
Lump sum over-compensation:	**£2,202,825**
Funds needed per year (work):	£50,000
Funds available at 2% (work):	£83,821
Funds needed per year (care):	£30,000
Funds available at 2% (care):	£68,858
Total over-compensation per year:	**£72,679 until 65; £38,858 after 65.**

Example 2: A 30 year old female is disabled in an accident and cannot work again. She has no educational qualifications and it is determined she would have earned £20,000 a year until retirement at 65. Rest of life care is determined to be £100,000 a year. She receives a lump sum at -0.75 Discount Rate, but is then able to achieve a real return on investment of 2%.

Lump sum at -0.75 DR:	£8,284,050
Lump sum at 2% DR:	£3,820,050
Lump sum over-compensation:	**£4,464,000**
Funds needed per year (work):	£20,000
Funds available at 2% (work):	£31,580
Funds needed per year (care):	£100,000
Funds available at 2% (care):	£223,238
Total over-compensation per year:	**£134,811 until 65; £123,238 after 65**.

Example 3: A 7 year old girl is severely disabled in an accident and will require care of £300,000 per year, with a stated life expectancy of 25 years. She receives a lump sum at -0.75 Discount Rate, but is then able to achieve a real return on investment of 2%.

Lump sum at -0.75 DR:	£5,784,000
Lump sum at 2% DR:	£4,542,000
Lump sum over-compensation:	**£1,242,000**
Funds needed per year (care):	£300,000
Funds available at 2% (care):	£382,034
Total over-compensation per year:	**£82,034**

Example 4: A 7 year old girl is severely disabled in an accident and will require care of £100,000 per year up to the age of 11, £130,000 per year up to the age of 19 and £230,000 per year from the age of 19 onwards, with a stated life expectancy of 50 years. She receives a lump sum at -0.75 Discount Rate, but is then able to achieve a real return on investment of 2%.

Lump sum at -0.75 DR:	£10,300,741
Lump sum at 2% DR:	£5,475,000
Lump sum over-compensation:	**£4,825,741**
Avg. over-compensation per year:	**£187,451**

Appendix C – Dual Rate

Potential New Methodology for Calculating the Ogden Discount Rate
This section describes a potential new methodology of a "dual rate" for calculating the Discount rate.

1. What do we ideally need from a new methodology?

a) A calculation basis that is formulaic and simple to understand
b) A resultant discount rate that changes relatively infrequently, but equally isn't left unchanged for too long if economic conditions change materially
c) A basis that reflects an appropriate level of investment risk, e.g. very low risk but not risk-free
d) A basis that reflects the very long time horizon that lump sum settlements are intended to cover
e) A basis that doesn't under- or over-compensate claimants

In our view the Lord Chancellor's interpretation of the current methodology fails b), c), d) and e).

2. Dual Rate Basis
Background
A dual rate methodology is used in some parts of the world. There are variations used particularly in the State of Ontario in Canada and Hong Kong: it is important to understand that these two models are themselves different (this is explained further below). In our view the model used in Ontario is preferable to that used in Hong Kong.

A dual rate mechanism recognises the problem of using a "single" discount rate to determine lump sums that are often calculated as the present value equivalent of very long payment streams (e.g. 50 years plus in many instances). To assume that risk-free real yields will perpetually remain at the current depressed levels in effect ignores the longer term average returns that have been achieved historically, and that are likely to be achieved again in the future.

The dual rate overcomes this flaw by setting rates that recognise that settlements covering shorter durations may require a different assumption to settlements covering longer durations.

The essence of a dual rate is therefore the recognition that better returns on investments can be gained over longer periods of investment. Where investment is limited to a shorter period, and in that period there is also the need to draw down the capital, returns are likely to be lower.

So, a dual rate is usually split into a "long term" rate and a "short term" rate.

Hong Kong

The model used in Hong Kong actually produces three separate discount rates:

1) For claimants with future needs not exceeding 5 years: minus 0.5%;

2) For claimants with needs not exceeding 10 years: plus 1%; and

3) For claimants with future needs exceeding 10 years: plus 2.5%.

The rates have been set via Court of Appeal decisions rather than in statute but take into account expert economic and actuarial evidence. These rates are not stepped, only one rate will apply for the duration of each claimant's future needs. So for a claimant with losses projected over a 40 year period, the discount rate throughout will be the long term rate of 2.5%.

This is not the model which we endorse, in that it fails to recognise the distinction between the **periods** of investment in any individual case and it may create hardship for claimants with losses limited to a period of 15 or 20 years.

Ontario

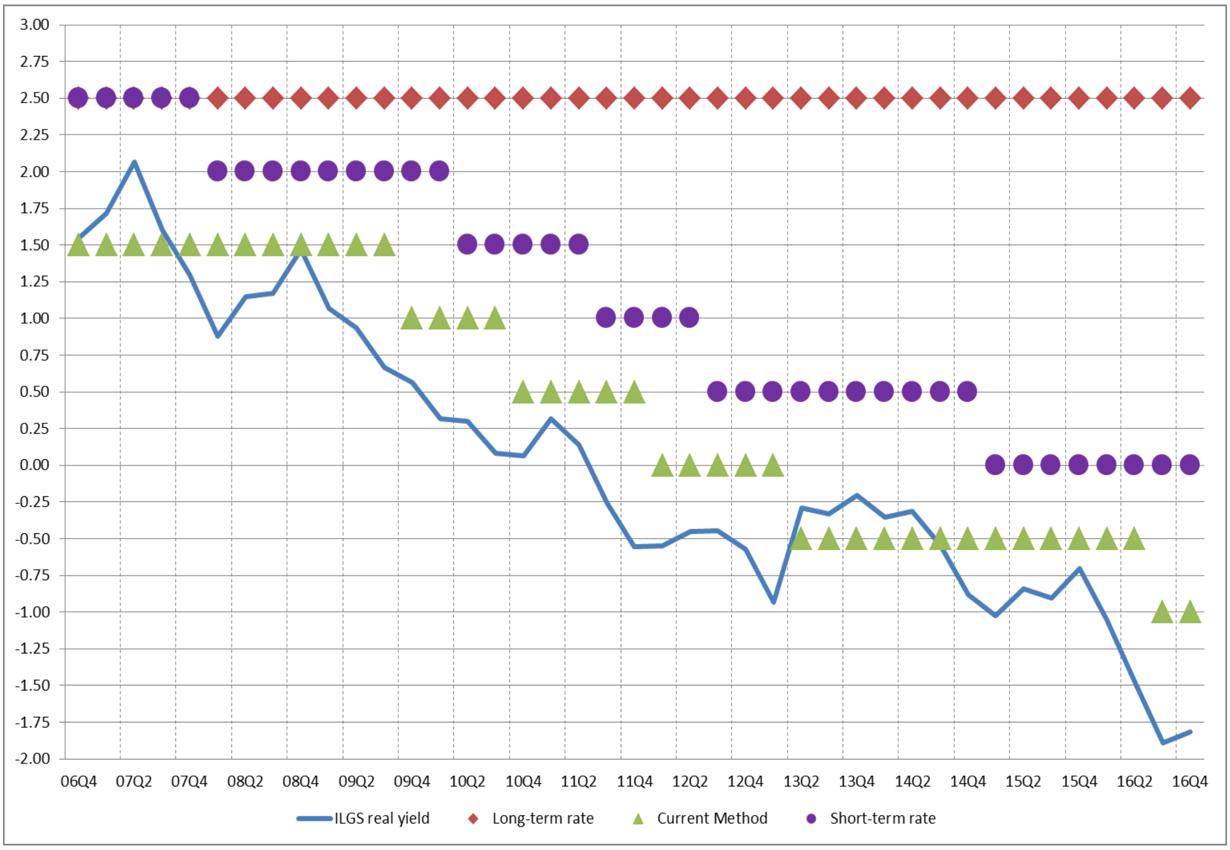
In this example the long term rate is defined in statute and remains fixed at 2.5%. This applies for the period over 15 years in any case. For the period less than 15 years in any case there is a short term rate which is variable - updated once per year, based on then-current real return yield rates. Since 2013 the lower rate has moved between 0.5% and -0.5%. It is calculated in Q3 of a given year and announced and comes into effect from the 1st January of the next year. In 2017 the short term rate is currently 0%.

The important distinction between this methodology and that used in Hong Kong is that the short term rate applies to the first 15 years of losses in **every** case. This is more consistent with the underlying recognition of the likely difference in investment returns for longer and shorter periods. Our belief is that the Ontario model is fairer to both claimants and defendants than the Hong Kong model.

Putting the Ontario model into a worked example, a two-tier format would be of the form:

- Discount rate =**S** for short-term period of the claim up to **Y** years, and **L** for the duration of the claim that exceeds **Y** years
- The derivation of S could be similar to the current methodology, potentially with some allowance for a very low investment risk margin.
- L could be determined as part of the consultation process and would reflect the real investment returns expected for longer term investments, again potentially with some allowance for a very low investment risk margin (either the same as for S or different).
- Y could also be determined through consultation, but for example 10 or 15 years may be appropriate.

The green triangles represent the discount rate that would have been derived using the existing methodology (if the rate had been reviewed throughout), the red diamonds represent the long-term rate L, and the purple circles represent the short-term rate S.



3.00
2.75
2.50
2.25
2.00
1.75
1.50
1.25
1.00
0.75
0.50
0.25
0.00
-0.25
-0.50
-0.75
-1.00
-1.25
-1.50
-1.75
-2.00
06Q4 07Q2 07Q4 08Q2 08Q4 09Q2 09Q4 10Q2 10Q4 11Q2 11Q4 12Q2 12Q4 13Q2 13Q4 14Q2 14Q4 15Q2 15Q4 16Q2 16Q4
ILGS real yield
Long-term rate
Current Method
Short-term rate