Joint Response to the Call for Evidence by the Justice Committee – Committee Stage – Damages (Return on Investment) Bill

From the Forum of Insurance Lawyers Northern Ireland and the British Insurance Brokers' Association.

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?

FOIL NI and BIBA (the joint signatories) acknowledge the new proposed statutory methodology for calculating the personal injury discount rate in Northern Ireland as infinitely preferable to the current methodology used under Wells v Wells, under which the Minister's recent announcement to strike a rate at -1.75% is based.

The proposed new methodology is based on the Scottish framework (per Damages (Investment Returns and Periodical Payments) (Scotland) Act 2019) with one main difference, namely the use of a *longer* assumed investment period of 43 years (as used in the English model set up following the Civil Liability Act 2018) rather than the *shorter* 30-year period used in the Scottish model. In the view of the joint signatories, with that amendment, a Scottish based framework is more likely to achieve as close to 100% compensation as possible.

In the context of the urgent need to complete consideration of the current draft Bill before the Assembly, the joint signatories would not at this time seek to argue that a model based on the English framework (as per the Civil Liability Act) would be preferable. However, if the passage of the current draft Bill were to be delayed further, the joint signatories would wish to return to the Committee with further submissions reserving their positions in relation to arguments around the efficacy of a methodology for calculating the personal injury discount rate using the English model. In this FOIL NI and the ABI would refer to the content of their original submissions to the Minister on the reform of the discount rate as part of the public consultation.

Question 2 – Has the new methodology the potential to veer towards overcompensation and if so how can this be rectified?

The prescribed nature of the notional investment portfolio as set out in the Bill, is a diversified low-risk portfolio. In being diversified rather than based exclusively on 100% ILGs it will avoid the pitfalls of likely over-compensation which flows from the current Wells v Wells-based methodology.

However, due to the type of investment and the percentage holdings prescribed within the notional portfolio, a more conservative and risk-averse investment model has been produced when compared to the portfolio that was used by the Government Actuary Department when it advised the Lord Chancellor in England and Wales (when the new PIDR was struck under the new reformed methodology set out in the Civil Liability Act 2018).

As a consequence, as the Bill uses the same set of investments and percentage holdings as was used in the Scottish legislation, a *lower* gross rate of return may therefore be produced, which is a factor which will influence the possibility or likelihood of over-compensation. Using different parameters to those prescribed within the Bill, may materially influence the personal injury discount rate which is then produced.

In the English methodology set up under the Civil Liability Act 2018 (CLA) (where the resulting rate struck was -0.25%) the details of the investment portfolio are left to the discretion of the Lord Chancellor subject to certain assumptions that the Plaintiff will invest in a diversified portfolio and be willing to take more risk than "very low risk" (as per the Wells v Wells methodology) but less risk than a prudent advisor who is properly advised. In its advice to the UK government, GAD recommended a midpoint of the portfolios which had been proposed by the respondents to the consultation announced under the CLA 2018. By taking that approach and formulating advice to the Lord Chancellor, a *slightly higher* risk was assumed than that which is now prescribed in the Scottish model – and which is mirrored in our draft Bill.

In evidence to the Scottish Economy Energy and Fair Work Committee (6th November 2018) the Minster Ash Denham acknowledged that the composition and makeup of the notional portfolio chosen in the Scottish Bill reflected a "*very cautious*" but low risk portfolio. In essence, the difference in composition and selection of investments within the notional portfolios, is one of the key differences between the methodologies used in England and Wales under the CLA 2018 and in Scotland under the Damages (Investment Returns and Periodical Payments) (Scotland) Act 2019 leading to the notional "lower risk investor" in England and Wales; and the "cautious investor" in Scotland.

Apart then from the cautious approach to risk evidenced by the composition of the same portfolio used in the proposed new methodology, another factor which might tend towards over-compensation is the use of an additional adjustment to the gross rate of return namely the *further margin* or *margin of prudence*. It is accepted in both England/Wales and Scotland that the cost of taxation and investment advice should be considered when striking the rate. Currently the two jurisdictions are in fact using the same standard adjustment for taxation and investment price (0.75%) and further margin/margin of prudence at 0.5%. Although the standard adjustment and further margin are currently the same in both England/Wales and Scotland, that might not necessarily remain the position after future planned reviews at five-year intervals. Both the standard adjustment and the further margin are prescribed in the new methodology as in Scotland.

In England and Wales, the standard adjustment for taxation/expenses must be taken into account by the Lord Chancellor but the amount of that discount is at the discretion of the Lord Chancellor (subject to consultation). The *further margin* or *margin of prudence* is totally at the discretion of the Lord Chancellor.

It is in the use of the further margin that a significant potential for over-compensation arises. It is clearly a policy device with the express objective of guarding against the risks of under-compensation. It is a blunt instrument at best. If the composition of a mixed portfolio had the goal of achieving 100% compensation to the injured Plaintiff, one has to question why there is any need to then use such a method to apply an additional adjustment downward of the gross rate of return by 0.5%.

In the Policy Memorandum which accompanied the Scottish Act it was expressly acknowledged that the application of the "further margin" would inevitably lead to a probability of over-compensation. The Scottish Government's position was that nonetheless the further margin was needed in order to recognise that "…any investment, however carefully advised and invested, may fail to meet [the injured Plaintiff's] needs" (paragraph 71, page 19).

If therefore there is one single feature of the new methodology proposed which has the potential to veer towards over-compensation, it is the application of the *further margin*. Whether it might inevitably lead to a probability rather than a possibility of overcompensation has already been flagged up by the Scottish Government within its Policy Memorandum which accompanied the 2019 Scottish legislation.

As an alternative to such a blunt 0.5% adjustment, the Committee might consider the use of rounding up of the rate calculated to a 0.25 margin.

How the application of the "further margin" might influence the PIDR can be seen looking back at the experience in England and Wales in 2018/2019 as a result of the new methodology introduced under the CLA 2018. If the then Lord Chancellor Rt Hon David Gauke MP had not applied the additional adjustment or "further margin" of 0.5% he would have arrived at a positive personal injury discount rate in 2019 at +0.25%. He chose however to exercise his discretion under the English model as Lord Chancellor to make a further downward adjustment of -0.5%, bringing the PIDR rate struck in England and Wales to -0.25%.

The Impact Assessment (July'19) carried out by the Ministry of Justice in England & Wales noted that had the Lord Chancellor accepted the Government Actuary's Report at that time, a net return of +0.25% would have resulted. This scenario had been based on "50:50 likelihood of over and under compensation". What happened next is informative. The Lord Chancellor viewed that "conclusion" as a step towards rather than the final outcome of the process and drew on the advice of the GAD on projected claimant outcomes. It focused on the likelihood of claimants being able to meet their needs and considered how the level of over/under-compensation would change under different PIDRs. In simple terms the lower the PIDR, the lower the risk of under-compensation. The higher the PIDR, the higher the level risk of over-compensation. Notwithstanding the fact that by adjusting the rate by a factor of 0.5% would likely over-compensate a representative Plaintiff as under-compensate, the rate produced at -0.25% (in England and Wales) "still amounted, in the Lord Chancellor's view, to a reasonable prospect of a claimant receiving full compensation, while avoiding a serious risk of serious under-compensation while also reducing the current expected levels of over-compensation".

As events played out, the size of the standard adjustment for tax/advice and of the further margin that was chosen in England and Wales by exercise of the Lord Chancellor's discretion, turned out to be identical to those which were prescribed in the Scottish legislation. This may not work out in the same way when the rates are struck again.

Under the proposed new methodology in Northern Ireland, both the standard adjustment and the further margin will be prescribed at 0.75% and 0.5% respectively. They will be maintained at those levels at the next periodic review in 2024 unless the Department brings forward regulations to change them. Under the English model, whether or not there is any "further margin" applied and, if so, how much is totally at the discretion of the Lord Chancellor (or the Minister of Justice, to use the Northern Ireland equivalent).

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

No, in the view of the signatories the new methodology does not have the potential to veer towards under-compensation and accordingly no rectification would be necessary in that regard.

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

Although hard evidence on the point is very difficult to obtain, it is likely that the notional portfolio represents a more conservative investment strategy than that which Plaintiffs would be advised to pursue.

As a starting point, the new methodology proposed is a better reflection of how an injured Plaintiff would be advised to invest (namely in a low risk diversified portfolio) rather than the very low risk of investing in ILGs alone (as in the present Wells v Wells based methodology).

The Scottish Government's Policy Memorandum which accompanied the Damages (Investment Returns and Periodical Payments) (Scotland) Act setting out the policy behind the Bill, made clear that it was adopting a *different approach* to that which had formed the basis of the previous consultation (which had asked "about how awards were actually invested"). It cited the difficulties in attempting to set a rate based on how Plaintiffs have actually been investing and that data was either not available or was largely historical and therefore arguably not reliable. The Scottish Government accepted this and that by adopting the notional portfolio approach (which is also enshrined in the proposed Bill) it would "…reflect responses to the consultation that investing in a mixed portfolio of assets provides flexibility and is the best way of managing risk" (www.scottish.parliament.scot/documents SP Bill 35-PM, paragraph 68, page 18).

It makes a number of assumptions which might not properly reflect investment behaviour. It assumes "passive returns" on investment from a set asset allocation and also with a constant (i.e. unchanging) investment objective. The fixed, prescribed nature of the notional portfolio set out in the Bill does not allow for the asset allocation to alter over time which might otherwise occur in a real-life investment. By assuming passive or bench mark returns under each asset type, the exposure to the possibility of greater returns on the investment, is reduced.

Finally, the notional portfolio prescribed in the Bill is identical to that used in Scotland and therefore is open to the same criticism namely that it is arguably underweight in terms of equities and overly cautious.

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?

Using a 43-year notional investment period (rather than 30 years as in the Scottish model) would more accurately reflect the average or typical investment period for a lump sum award of damages. The ABI submission to the Scottish Government's call for evidence around changes to the PIDR in Scotland indicated that the average life expectancy following a serious personal injury claim (where damages were in excess of £250,000.00) was in fact 46.

The use of a longer notional investment period of 43 years would also have the potential to increase returns on investment and as a consequence lower the likelihood of under-compensation [refer to Impact Assessment dated July 2019 - page 16/17 – Table 6: Summary of impacts of deviating from baseline assumptions on returns].

Although the 43-year period is also presently used in England and Wales (since 2019) the difference going forward in Northern Ireland will be that this period is prescribed at 43 years and it will therefore not be within the discretion of the Minister of Justice to consider altering that date, as would be the case in the English model. The new methodology does however confer power on the Department of Justice to change the period of 43 years by regulations (subject to the affirmative procedure) [paragraph 8, new Schedule C1 to the 1996 Damages Act].

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 new statutory methodology would appoint the Government Actuary as the *rate assessor*. The arguments put forward are that in doing so, the exercise of determining the personal injury discount rate in Northern Ireland is removed from the political arena and therefore in some way cocooned from external pressures. In *prescribing* the list and composition of investments within the notional portfolio in the legislation, it is argued that the Government Actuary's role is purely an actuarial one.

The new methodology will set the parameters for the Government Actuary to calculate the appropriate rate and then report to the Department of Justice. The final say however on what the figure is, under the proposed methodology will lie with the Government Actuary.

In reality it is questionable if the Government Actuary can carry out its role devoid of any other considerations or parameters, other than those prescribed in the legislation. For example, economic performance and volatility of investment markets are key issues. The Government Actuary in the "The Personal Injury Discount Rate - Review and Determination of the rate in Scotland" (27th September 2019) acknowledged that the Scottish framework, upon which the new methodology is largely based, set out many material parameters for his assessment of the PIDR. However, Martin Clarke (the Government Actuary) added, "…it is still necessary for me to make a number of *other assumptions* in relation to the returns that I have modelled on the notional portfolio".

He then listed those assumptions at paragraphs 3.7 to 3.14 and in the following section 4 he discussed also the "sensitivity" of the rate which is produced by reference to those assumptions.

In choosing what other assumptions to make, other than those material parameters which are set out in the legislation, the Government Actuary acknowledged that he would be looking both in-house and to other publicly available views of other investment managers and advisors. Therefore, whilst GAD might be seen to be completely constrained by the parameters set out in the legislation and carrying out an actuarial exercise, the Actuary has acknowledged that it is still necessary for him to make *other assumptions* such as "economic assumptions" (to cover simulations of future inflation); and "asset class interpretation" (to "best represent and model" those assets which are prescribed in the notional portfolio). In addition, in considering the "approach to investment" the Government Actuary acknowledged that it was assumed that asset allocation would remain constant over the entire investment period, that it will be "passive" and not "active" and that the investment objective would remain unaltered.

In the English model, the same Government Actuary in advising the Lord Chancellor may consider the same "other assumptions". The Scottish model, upon which the new statutory methodology is based, might be viewed initially as somehow different to the English model in that the Government Actuary's role is an actuarial (or objective) exercise when in fact both models are likely to be at least in part influenced by similar assumptions or factors, which are not expressly referenced within either statutory framework.

Arguably, therefore, GAD's exercise in striking the PIDR will require a range of considerations and decisions. In what sense then are those decisions and choices which are made by the Government Actuary an exercise of actuarial expertise and experience or an exercise of discretion by the Government Actuary without immediate political oversight or accountability? Under paragraphs 23-25 of the proposed new Schedule C1 to the 1996 Damages Act the Government Actuary as the rate assessor will set the rate in a report presented to the Department of Justice which must be laid before the Northern Ireland assembly (as soon as practicable) and on that same day it must be published. The rate comes into effect the following day.

Under the new statutory methodology then, political oversight and/or accountability comes into effect after implementation of the rate. The Bill does provide the Department of Justice with powers to make regulations to both change the composition of the list of investments and the percentage holdings (paragraph 12). Paragraph 16 *requires* the Department of Justice to review the composition of the notional portfolio to consider whether it remains appropriate with references to the characteristics and objectives of the *hypothetical claimant investor* as described in Paragraph 17. The Department is required to carry out that review at each subsequent review following the striking of the initial rate. The first opportunity will therefore present itself at some point prior to the 1st July 2024 review, which is set to align Northern Ireland with the review of the rate in Scotland. In carrying out this mandatory review, Paragraph 17(2) - the Department must consult but the draft legislation does not define *with whom,* only "*as it considers appropriate*".

It is therefore for the Committee to consider the degree to which the Government Actuary's involvement and role in striking the rate is politically accountable. The key consideration in achieving the principle of 100% compensation is in striking a fair balance between the Plaintiff and the Defendant and between the risk of over and under compensation.

By choosing a new methodology based largely on the Scottish model (save for the 43-year prescribed duration of the notional investment portfolio), it may be that the Committee consider that appropriate political judgement and balancing have already been carried out. This is reflected by the composition of the notional investment portfolio, the extension of the duration of the notional investment period from 30 to 43 years and in prescribing a *further margin or margin of prudence* in the legislation of 0.5%. Each of those factors will have an influence on the PIDR and on the balance between under and over-compensation. They come however pre-prepared and mainly borrowed from the Scottish experience. In a sense are they oven ready? That is the question for the Committee.

If there is a disadvantage of the new methodology, it is the lack of flexibility which is caused by the more prescriptive approach - both in terms of the composition of the investment portfolio and the prescription of the further margin to be applied. In times of economic uncertainty and market volatility, it is for the Committee to consider whether decisions around the PIDR should rest with the Government Actuary or with the Department of Justice.

In summary, the joint signatories would urge the Committee to consider how best to properly consider and scrutinise the draft Bill with a view to having a reformed methodology for striking the discount rate in Northern Ireland in place at the earliest opportunity. The need to do so is all the more immediate given the Minister's decision to proceed with a new PIDR under the current Wells v Wells based methodology - as from 31st May 2021. A rate of -1.75% will not achieve 100% compensation in the sense that it will carry with it a significant risk of over-compensation based on the previous analyses carried out by the Government Actuary. On that basis, the new methodology proposed in the Bill will restore a fairer balance to the risks of under and over-compensation which surround the striking of an appropriate PIDR.

Apart from the composition of the notional portfolio as set out in the new methodology, which in the view of the joint signatories is cautious and light in equities, the one part of the Bill that could be re-considered and either removed or amended, is the "further margin" prescribed at 0.5%.If the Committee were not minded to remove the further margin in its entirety, as an alternative the Committee might consider a proposal previously made by the ABI: that when setting the rate by reference to a quarter percentage point, that the rate is rounded up rather than down.

The joint signatories look forward to assisting and working with the Committee and would welcome the opportunity to give evidence to the Committee if appropriate or required.