ECONOMY, JOBS AND FAIR WORK COMMITTEE

BUSINESS SUPPORT INQUIRY

SUBMISSION FROM Professor Victoria Wass

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

General

1. What are your views on the Bill overall? Is legislation in this area required? How far do you think the Bill will achieve what it sets out to do?

This submission is made in a professional capacity and draws on past and current experience and research as an academic and as an expert witness providing advice on the value of personal injury claims. I am a member of the Ogden Working Party and I was an expert in the first PPO cases decided in England and Wales where I advised on indexation. My submission addresses the question of the fairness of the proposal to change the basis for the calculation of the discount rate from the return on ILGS to that on a low risk mixed portfolio and the robustness of the Government's analysis upon which the proposal is founded and upon which its impact is assessed. This submission is consistent with evidence that I submitted to the Justice Committee Inquiry of the Westminster Parliament (Wass 2017a and House of Commons Justice Committee (HCJC) 2017a) which was widely cited in its subsequent report (HCJC 2017b). The Justice Committee identified a lack of clarity on the meaning of 100% compensation and the change in assumptions on how the lump sum should be invested. I seek to provide greater clarity on this here. The arguments presented in this submission are more fully developed in an academic paper (Gunn and Wass, forthcoming) which has been accepted for publication in the Journal of Personal Injury Law which I have made available to the Committee.

My view is that the premise of the Bill that pursuers are over-compensated by a 'risk-free' PIDR is false so that one of the objectives of the Bill – fairness – fails. If pursuers are not over-compensated then the Bill is unfair to pursuers. The Bill also represents a retreat on the principle of full restitution (100% compensation). The ability of a PIDR based on redemption yields achieved on ILGS to best achieve the objective of the law (the 100% principle) was proposed by the Law Commission Report of 1994 and accepted in the judgment in *Wells v Wells* [1999]. The proponents of the Westminster Bill have provided neither a theoretical case nor robust empirical evidence that either of these authorities are wrong. Without this evidence, this a political decision which will see pursuers disadvantaged in favour of defenders. Legislation is required to change the principles and methodology for the setting of the PIDR because such a change would not survive the scrutiny of a court (see Lord Hutton *Wells v Wells* [1999] para 405). In short, if pursuers are not over-compensated by a risk-free PIDR, then the Bill is a retreat from the 100% principle and fails on its ambition to deliver fairness. It is unfair to pursuers.

Part 1

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

do you believe the reform will achieve all these things – a clear, certain, fair, regular, transparent and credible method and process?

I support the aims but I do not consider that the proposed reform achieves the most important of them. It does not achieve fairness and it makes the financial outcome for pursuers more not less certain. It adds further risk to those the pursuer already faces. It is my view that Lord Keen and the MoJ are mistaken in their conclusions that pursuers are over-compensated by a risk-free PIDR. It has not been proved that they are. The evidence relied upon to support the conclusion of over-compensation, that pursuers are observed to invest in risky assets, does not (see (a) below) and, more importantly, cannot (see (b) below) support a conclusion of over-compensation.

(a) Empirical evidence on over-compensation

The Bill relies upon research and more general observation that pursuers do not invest all or even the majority of their lumps sums in ILGS. The conclusion is that if they invest in a mixed portfolio, they achieve a return in excess of that assumed in the PIDR which is based on ILGS and they are therefore over-compensated. The finding is ambiguous in its interpretation and does not provide the support for the over-compensation which justifies the Bill. The research does not observe claimants' investment behaviour in a risk-free environment so that claimant investment in risk-bearing assets is also consistent with an under-compensation explanation for the reasons outlined below. There are four sources of risk facing a pursuer in receipt of a lump sum award which would lead him/her to invest in risky assets.

(i) **Longevity risk** - out-living their predicted life-expectancy would mean that they would be unable to fund their recommended care plan for the period between expected and actual death. They would need to fall back on LA provision for any social care or rely on friends or family. The complex nature of their care needs makes this very unattractive and very likely unfeasible.

(ii) **Built-in discount rate shortfall** - the assumed PIDR (based on a three-year average) exceeds current redemption yields on ILGS, both currently and historically (see Gunn and Wass forthcoming).

(iii) **Real growth shortfall** – real growth, reflecting improved quality, is excluded from the valuation of the claimant's need for care and assistive technology under the *Cookson v Knowles [1978]* rule. A PIDR based on ILGS returns provides protection from RPI inflation but is insufficient if future needs are expected to increase by more than RPI inflation. The claimant's needs are assumed to remain constant in terms of quality but the reality is that the claimant must purchase more expensive assistive technology, meet real wage inflation in care costs, therapies, professional Deputies and more expensive forms of care provision than was envisaged at the time of settlement (eg WTR and sleepover rates, manual handling and double-up carers). The reality is that it is not possible to purchase today what was the state of the art care provision or prosthesis technology from 20 years ago. Similarly, it is unlikely that the current state of the art care and prosthesis technology will be available to purchase in 20 years from now. A claimant's award must adapt to such qualitative change if it is to meet the 100% principle.

(iv) Accommodation shortfall - the claimant is seeking to manage the purchase of suitable and more expensive accommodation for which provision under *Roberts v Johnson* is insufficient, no matter what statutory PIPDR is set. This is because property values have grown exponentially since *RvJ* was decided, whereas awards for pain suffering and loss of amenity (PSLA) (the supposedly spare capital in an award) have not.

Most of the data on pursuers' investment behaviour (including from the Court of Protection, Law Commission 1994 and research commissioned by the MoJ in 2010 and published in MoJ (2013) comes from the long period where the assumed real net return of 2.5% (and above) was guaranteed to leave the claimant with a shortfall if invested in ILGS. The research commission by the MoJ included testimony from pursuers and their advisors that revealed pursuers dealing with a great deal of risk, including from the sources set out above. When pursuers are observed to expose themselves to investment risk, it is largely to avoid other risks in relation to their lump sum being exhausted before their death. As indicated below, pursuers are juggling to manage a range of different risks in order to minimise their overall risk. Pursuers are revealed to be ill-equipped to do this but manage as best they can and suffer losses when the value of equities falls.

> *We only got half of what we knew he needed, therefore we couldn't invest his money in completely safe options, there had to be a modicum of risk that would produce enough money to last a lifetime.*
> *It was moderate risk, we didn't go any higher than moderate … Since we got the money we've been through two major stock market crashes, so we've probably wiped off at any one time £800,000 from his portfolio. If we'd have been given enough we could have stuck to low-risk investments.*
>
> Parent/ carer of claimant, clinical negligence (MoJ 2013 p49)
>
> *Most of these people have had a really bad deck of cards … They all tend to be aware of how things can go wrong in the blink of an eye and they are not people who are inclined to take risks.*
> Claimant solicitor (MoJ, 2013 p48)

Over- or under-compensation is not a matter that can be settled definitively with recourse to empirical evidence because we cannot observe pursuers' investment behaviour in a no-risk environment. What is observed is pursuers' behaviour in a risky environment, that is pursuers' behaviour when bearing the risks and shortfalls outlined in (i) to (iv) above. Instead the choice between the under- and over-compensation explanations must be made at an intellectual level. Which is the more credible: pursuers investing to minimise risks and shortfalls elsewhere in the claim (which we know exist) or pursuers preferring to take on risk from a position of no-risk in order to make a financial gain (that they might want but don't need)? Again it is helpful to listen to pursuers:

> High risk is not something for people in our position – [you need] the money for house, pain relief and salary not holidays. That's why you don't want high risk – you can't risk these things.
> (Claimant with spinal injuries, RTA, MoJ 2013 p 48)

(b) Theoretical case for over-compensation

If the empirical case for or against over-compensation is difficult to prove, the conceptual case against the Bill is decisive. Its proof requires some undergraduate economics. The arguments are set out diagrammatically in Gunn and Wass (forthcoming). They are equally available using maths, though possibly less accessible to this committee. Both provide a rigorous and robust proof without the potential for confusion caused by 'alternative definitions' of 100% compensation.

The reasoning is presented here at an intuitive level. The Committee is referred to Gunn and Wass (forthcoming) for a detailed proof. For a risk-averse individual, the utility gained from wealth increases with wealth but at a decreasing rate. The intuition is sensible: an additional £100 has greater subjective value to you when you are relatively poor compared to when you relatively wealthy. This follows directly from risk-aversion and all sides in the Westminster debate were in agreement that the claimant is risk-averse (See Lord Keen "*of course, they are risk-averse"* (HCJC 2017a Q92)).

Bearing risk imposes a cost on a risk-averse pursuer. This is a property of the utility function defined above. The relative increase in utility from a gain is less in absolute terms than the reduction in utility from a loss. Therefore a risk-averse individual will always prefer a certain sum to the equivalent expected value of that sum in a bet. And will never take a fair bet. The risks faced by the pursuers are all injury-related risks and would not have been present in the absence of injury. If the claimant is risk-averse and if the risks associated with the lump sum are all injury-related then, making the pursuer take on additional risk, without paying her to do so, is <u>by definition</u>, less than full restitution. It is only under the alternative definition of 100% compensation invented by the MoJ where pursuers will be awarded what they need (100% compensation) but they will need to invest to get it (take on risk), that overcompensation becomes a possibility. The alternative 100% definition is justified on the basis that pursuers are observed to invest in risky assets, even when their compensation assumes a risk-free discount rate. It appears that that risk is not too costly for them. In fact, pursuers must value making more than they need above failing to make what they need. It is this sense, of pursuers earning a 'profit', that is the evidence of over-compensation. At first sight, this might be a compelling argument. However, greedy risk-taking pursuers is not consistent with the findings reported in MoJ (2013). The flaws in the alternative definition and the premise of over-compensation are (a) pursuers behaviour is not being observed from a position of receiving a lump sum on a risk-free basis and (b) risk is costly for a risk-averse claimant so imposing the cost of this risk on the claimant, where the risk is one that would not have be there in the absence of injury, must deliver less than 100%.

3. No submission

4. No submission

5. No submission

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

The pursuer is not a hypothetical investor seeking the best returns. The pursuer is more like a hypothetical closed pension scheme meeting fixed liabilities from a fixed pot. This was the view of the House of Lords in *Wells v Wells* [1999]: "What the prudent plaintiff needs is an investment which will bring him the income he requires without the risks inherent in the equity market: which brings us back to ILGS" (Lord Lloyd para. 367). "Others like them with fixed outgoings at stated intervals take the same view as to prudent investment policy. So the plaintiffs are not alone" (Lord Lloyd para. 368). "The general practice for a closed pension fund is to invest in ILGS so as to be sure of being able to meet their liabilities as they fall due" (Lord Lloyd para. 368). The Pension Regulator does not permit a closed pension scheme to meet its future liabilities through a mixed portfolio. Rather a closed pension scheme is required to invest in ILGS or something very close to it. A mixed portfolio might provide flexibility to meet risk but at the very high cost of adding to the risks the pursuers already faces.

Part 2

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

For the reasons set out above, I agree that PPOs, correctly indexed, offer an opportunity for pursuers to minimise injury-related risks for (i) to (iii) above. My view is that poor uptake of PPOs is largely confined to non-government defenders and is driven by the reluctance of the general insurance sector to take on the very risks that are so difficult and costly for pursuers to manage. During oral submissions, the rates at which defenders were reserving for PPOs (an internal defender discount rate) were -0.8% for NHS Resolve (HCJC 2017a Q26) (currently -1.5%) and between -1.5 and -2.0% for general insurers (HCJC 2017a Q37, Q49 and Q51). The risk transfer from pursuer to defender when a lump sum is replaced with a PPO imposes the cost of risk on the defender. This explains the reluctance on the part of defenders to offer or agree to PPOs. A reserving rate of -1.5% also undermines the case presented in the Bill that pursuers are over-compensated by a PIDR of -0.75%.

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

Court powers to impose PPOs will alter the balance of bargaining power in the negotiations but may be insufficient to shift the form of award from a lump sum to a PPO. As above, PPOs impose substantial costs on a general insurer and they will seek to avoid an award in this form in Scotland as they have done in England and Wales.

9. No submission

Overall

10. The Bill overall is intended to support the Scottish Government's national outcome that: "We have strong, resilient and supportive communities where people take responsibility for their own actions and how they affect others". Do you have any comment?

The proposed Bill does not support this outcome. Pursuers who are disabled and unable to work and who require care will be less finically able to meet their needs, less resilient in the face of uncertainty and will likely require greater support from their communities because they will be less independent. The law is that the defender should take full (100%) responsibility for the financial impact of his/her tortious actions and the Bill represents a retreat from this.

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

No. The proposed Bill increases risk and uncertainty for pursuers at the expense of defenders. In my view the shift in risk from defender to pursuer has not been justified by the sponsors of the Bill.

Other comments

12. No submission

References

Gunn I and Wass V (forthcoming). Full restitution and the risk-free discount rate. *Journal of Personal Injury Law*. forthcoming December 2018.
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Wells v Wells [1999] AC 345.
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