Appendix D: Prior GAD Advice

MEMO

TO: Department of Justice NI

COPIED TO:

FROM: Government Actuary's Department

DATE: 20 November 2020

SUBJECT: Northern Ireland Personal Injury Discount Rate (NI PIDR)

Background

In 2019, the Government Actuary advised the Scottish Government on setting the Personal Injury Discount Rate (PIDR) at PI-0.75% pa. The rate was set based on the expected return on an investment portfolio over 30 years. The portfolio used in the determination was set based on advice from GAD with consideration of the asset allocation of cautious investment funds across the market at the time.

As part of their consideration of reforming the PIDR legislation in Northern Ireland, the Department of Justice Northern Ireland have asked GAD for advice on:

- Whether the investment portfolio used in the determination of the Scottish PIDR remains appropriate.
- Whether the investment period for consideration should be set to 30 years or another figure.

This note sets out our advice in these areas.

Investment Portfolio

The portfolio used for the Scottish PIDR was based on consideration of the asset allocation of 20 investment funds which were labelled as ‘Cautious’ by Morningstar. The graph below shows the different portfolio allocations for the different asset classes.

The recommended portfolio was proposed based by judgement and by visual inspection the graph below, rather than anything scientific. The main comments to note are:

- The hardest / most subjective choice was in respect of the allocation to bonds (i.e. allocation to and between nominal gilts, index-linked gilts, investment-grade corporate bonds and high-yield bonds).

Finlaison House
15-17 Furnival Street
London
EC4A 1AB

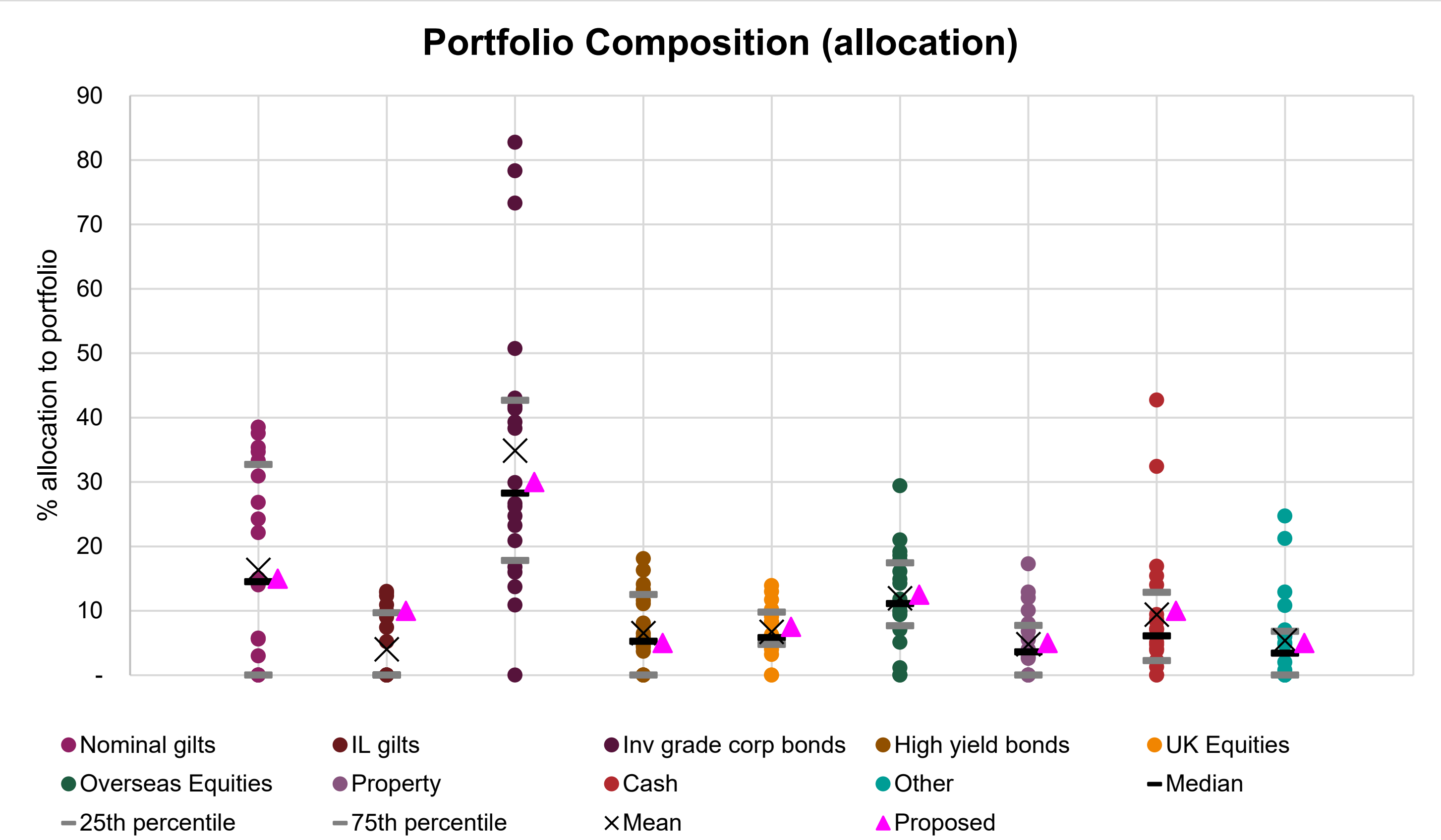
020 7211 2601

www.gov.uk/gad

- For most asset classes, the proposed allocation is broadly similar to the “average” allocation (on both a means and medians basis), rounded roughly to the nearest 2.5% to avoid spurious accuracy.

- The cash allocation is slightly higher than the median, but closer to the mean. This reflects the wide range of cash allocations and has been allocated to cash to ensure the portfolio sums to 100%.

- The allocation to “Other” also has a similar wide range / spread. Following discussions, it was decided that a 5% allocation was within tolerance and avoided requiring a more detailed breakdown.

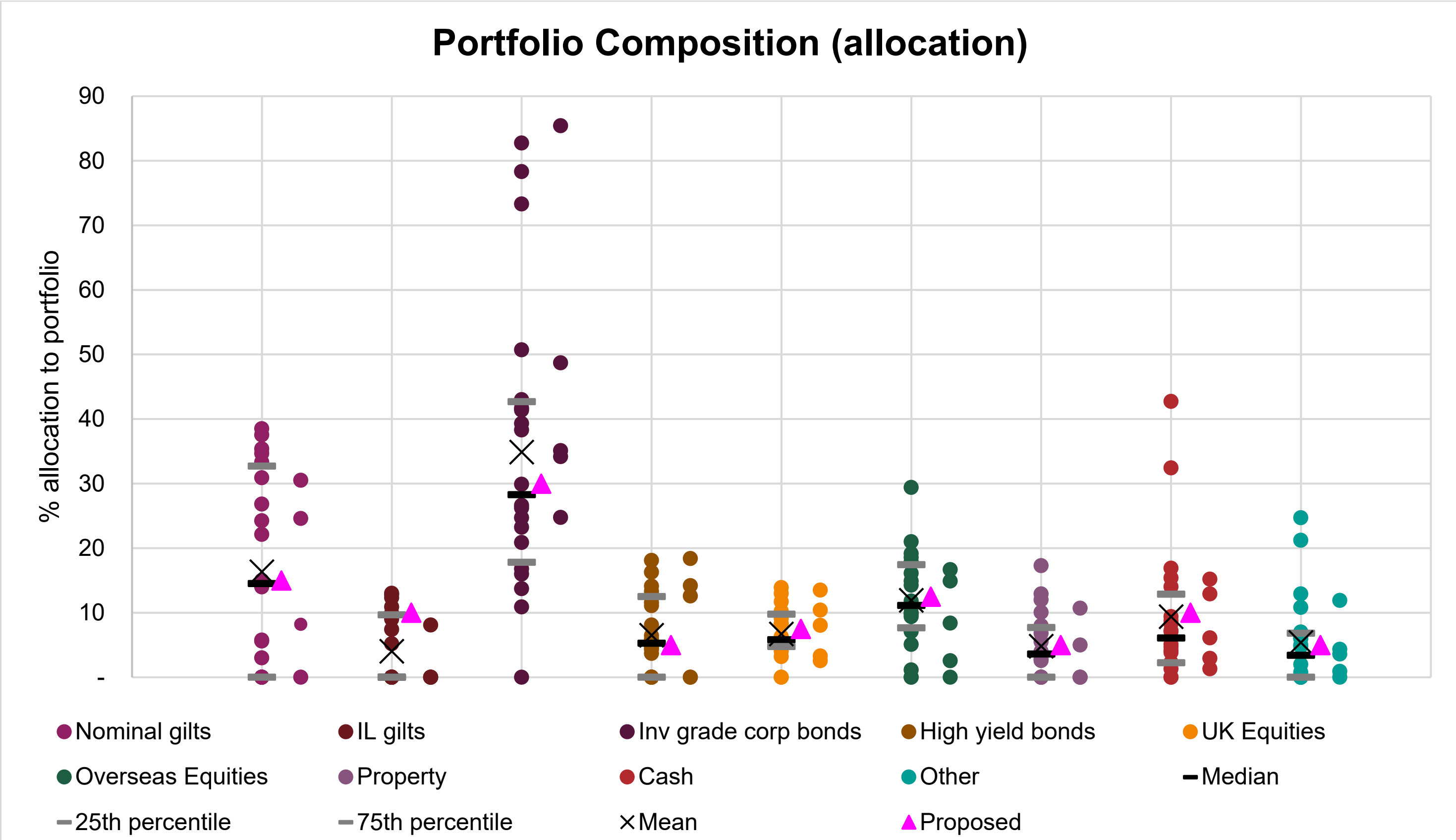


Investment managers will undertake regular reviews of their investment allocations based on their views of the relative value in different markets and of different asset classes. As such, it is likely that most managers will have made some changes to the asset allocations in the funds selected above. On the other hand, and in broad terms, the relative riskiness of the different asset classes is unchanged and so whilst we might see some movement between asset classes, we would not expect to see significant changes in the overall split between “defensive” assets (such as government bonds and cash) and “risk seeking” assets (such as equities). As such, our prior belief before carrying out any analysis is that the composition of the portfolio is still likely to be broadly representative of a low-risk investment portfolio.

To test this hypothesis and review the appropriateness of the portfolio, we have considered a sample of 5 of the funds that we considered for the Scotland PIDR portfolio to test the following:

- The strategy of these investment funds remained ‘cautious’.
- The asset allocations generally remained stable, and therefore our recommendation remained appropriate.

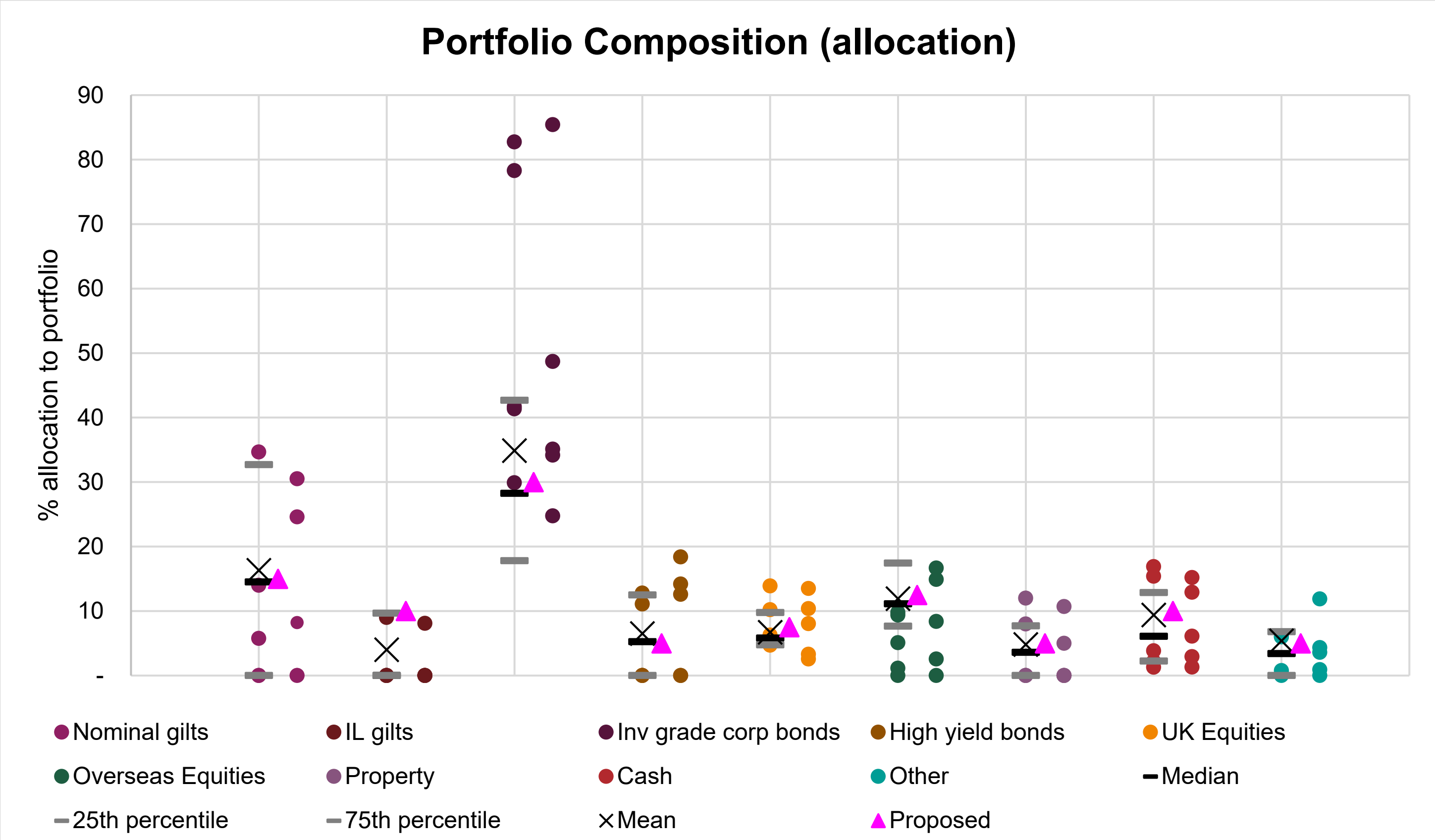
We have compared how the allocations to different asset classes outlined above has changed for these sample 5 funds. This is shown in the graph below. The circles on the vertical lines represent the asset allocations for the 20 funds selected for the Scotland PIDR portfolio. The circles to the right of these represent the sample funds.



Based on the sample 5 funds, we note the following:

- The assumed allocation to index-linked gilts which appears slightly high given the changes in our sample portfolios.
- In general, the rest of the portfolio composition seems appropriate. Our original assumptions remain broadly in the middle of the park for almost all of the asset classes when we consider the reduced 5 portfolios.

The second graph below illustrates how the portfolios have changed for the 5 funds we have selected.



From the graph and the data supporting the graph, we have noted the following:

- Investments in gilts has mostly fallen, with one fund moving to virtually no investment in gilts. Only 1 of the 5 portfolios maintained their asset allocation into gilts.

- Investment in investment-grade corporate bonds have increased for 4 of the funds. Similar investment in high-yield bonds has increased for all 3 funds who have invested in this asset class.

- 4 of the 5 funds have reduced their asset allocations in UK equities.

- 4 of the 5 funds have increased their asset allocations in Overseas equities.

- 1 fund has significantly reduced their cash allocation and increased their 'Other' holdings. Cash holdings for the other 4 funds are broadly similar, whilst 1 of the 5 funds have significantly reduced their 'Other' holdings.

Although there have been some changes for some asset classes, we would note that:

- It is possible that the current move away from some asset classes (in particular index-linked and nominal gilts) reflects current market volatility in light of the COVID-19 pandemic.

- We have only reviewed a relatively small sample

- The portfolio was only specified recently (albeit with significant market turmoil) which suggests that it is perhaps too early to identify any clear trends

- The portfolio that was advised for Scotland was intended to be an illustrative or possible low risk portfolio, rather than being specified to any particular manager or portfolio.

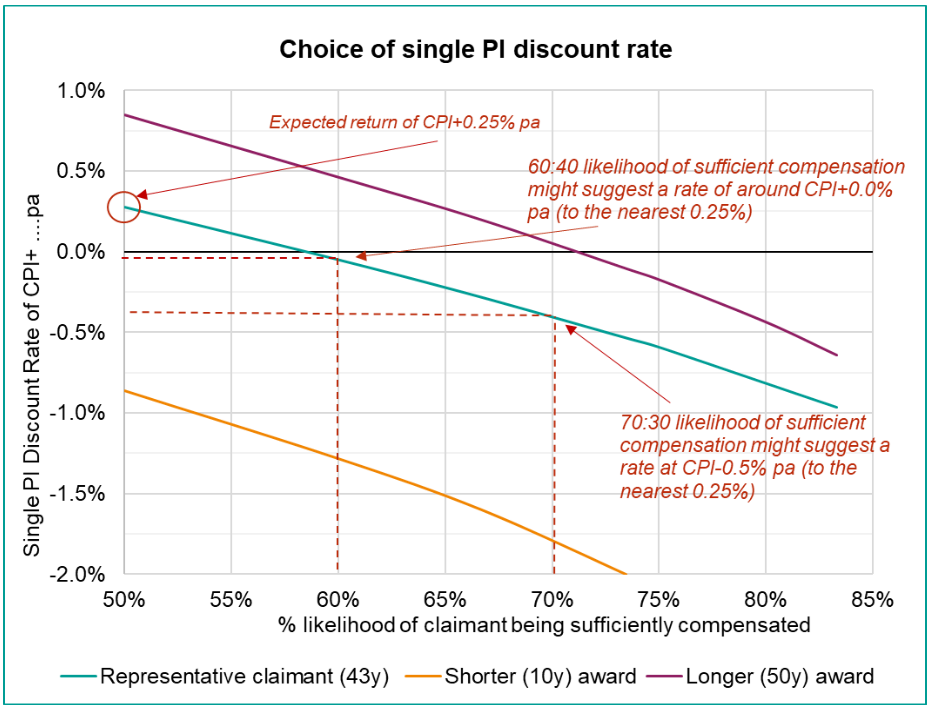
In summary, although investment managers have made some changes to the composition of the portfolio, we believe that these are generally small in comparison to the make-up of the whole portfolio and that the Scottish portfolio remains an appropriate illustrative low risk portfolio.

Investment period

Given that the PIDR is intended to reflect the expected investment return a claimant might earn on their lump sum award, the investment period should reflect the period over which claimants are investing. For many personal injury claims, this is likely to be linked to the claimant's life expectancy (assuming that damages are incurred for the rest of their life), but in some cases a different period might be suitable.

There is obviously a very wide range of personal injury claims that might give rise to very different investment horizons. For example, an infant might have a longer life expectancy and hence be expected to invest their damages for much longer than an elderly person. There is fairly limited data available on the life expectancy and investment period for personal injury claimants. However, as part of the call for evidence to inform the Government Actuary's, evidence was submitted that the typical life expectancy of personal injury claimants is around 40-45 years, which is why 43 years was used in our analysis for the Lord Chancellor.

One of the key considerations in setting the investment horizon is likely to be the impact that it has on different claimants. In the current environment, the choice of the investment horizon makes a relatively large impact on the resulting PIDR because we expect investment returns to be lower in the short term and higher in the longer term. We anticipate this situation is further exaggerated by the current COVID-19 crisis.



This point was illustrated in the Government Actuary's advice to the Lord Chancellor last year. The chart to the right shows how the likelihood of claimants being sufficiently compensated (on the horizontal axis) changes when the PI discount rate is varied (in excess of CPI on the vertical axis). Each line shows a claimant investing over different time periods.

The chart shows that setting a lower PI discount rate increases the likelihood of a claimant being able to meet their damage needs.

The chart also illustrates the difference in the expected investment return over different investment horizons (which is where the different lines meet the vertical axis). For example, under the assumptions used to advise the Lord Chancellor, the expected return on the portfolio would be:

- CPI+0.25% pa for the representative average claimant investing over 43 years
- CPI-0.75% pa for a claimant investing over a shorter period of 10 years
- CPI+0.75% pa for a claimant investing over a longer period of 50 years

We estimate that the difference between expected returns over 43 years (as used in our England and Wales advice) and 30 years (as used in Scotland) was around 0.1%-0.2% at the time that the assumptions were set.

In summary, there is no single or obvious way in which the investment period should be set and it is ultimately a judgement alongside other parameters in the process. The choice is likely to be a consideration of:

- Whether to set the PIDR with regard to the "average" claimant, or alternatively whether to take into consideration claimants with different investment horizons
- The level of prudence and caution that is set in other parameters and the impact of this in terms of the resulting likelihood of claimants being able to meet their needs and the relative balance between claimants and insurers (and their customers) who meet the cost of the claims.

For instance, it was noted by other respondents to our call for evidence that although many claims are indeed for a longer period, considering a 30 year investment period provides some margin of protection to claimants with shorter time-horizons, who are more likely to face the risk of lower investment returns over these periods.

As such:

- Setting a 43-year investment period might be suitable if it is considered appropriate to set the legislation with respect to the average claimant and there is a preference for setting explicit and separate margins that increase the likelihood of claimants being sufficiently compensated.
- Setting a 30-year investment period might be suitable if some consideration is to be given to claimants who are investing over the shorter term when investment conditions are expected to be more challenging and/or there is a preference for including caution in the assumptions/approach.